

FIRST KEYSTONE CORP
Form 10-K
March 15, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 2015**

or

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

For the transition period from _____ to _____

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its Charter)

Pennsylvania

(State or other jurisdiction of incorporation)

23-2249083

(I.R.S. Employer Identification Number)

111 West Front Street Berwick, Pennsylvania

(Address of principal executive offices)

18603

(Zip Code)

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

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

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

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

Yes No

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

Yes No

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

Yes No

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

Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

Yes No

The aggregate market value of the registrant’s outstanding voting common stock held by non-affiliates on June 30, 2015 determined by using a per share closing price on that date of \$25.00 as quoted on the Over the Counter Market, was \$125,857,750.

At March 1, 2016, there were 5,620,205 shares of Common Stock, \$2.00 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant’s 2016 definitive Proxy Statement are incorporated by reference in Part III of this Report.

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PART I

Forward Looking Statements

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

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

our ability to manage current levels of impaired assets; deposit flows; the loss of certain key officers; our ability to maintain the value and image of our brand and protect our intellectual property rights; continued relationships with major customers; the potential impact to the Corporation from continually evolving cybersecurity and other technological risks and attacks, including additional costs, reputational damage, regulatory penalties and financial losses; and weak economic conditions.

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

ITEM 1. BUSINESS

General

First Keystone Corporation (the “Corporation”) is a Pennsylvania business corporation, and a bank holding company, registered with and supervised by the Board of Governors of the Federal Reserve System. The Corporation was incorporated on July 6, 1983, and commenced operations on July 2, 1984, upon consummation of the acquisition of all of the outstanding stock of First National Bank of Berwick (the predecessor to First Keystone Community Bank). The Corporation has one wholly-owned subsidiary, First Keystone Community Bank (the “Bank”), which has a commercial banking operation and trust department as its major lines of business. Since commencing operations, the Corporation’s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank. Greater than 98% of the Corporation’s revenue and profit came from the commercial bank subsidiary for the years ended December 31, 2015, 2014, and 2013, and was the only reportable segment. At December 31, 2015, the Corporation had total consolidated assets, deposits and stockholders’ equity of approximately \$983 million, \$721 million and \$108 million, respectively.

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

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

The Bank’s legal headquarters are located at 111 West Front Street, Berwick, Pennsylvania, from which it oversees the operations of its eighteen branch locations. These locations consist of five branches within Columbia County, eight branches within Luzerne County, one branch in Montour County, and four branches within Monroe County, Pennsylvania. For further information, please refer to Item 2 – Properties, and Note 13 – Commitments and Contingencies in the notes to the consolidated financial statements.

The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in its Northeastern Pennsylvania market area. The Bank’s commercial banking activities include accepting time, demand and savings deposits and making secured and unsecured commercial, real estate and

consumer loans. Additionally, the Bank provides personal and corporate trust and agency services to individuals, corporations and others, including trust investment accounts, investment advisory services, mutual funds, estate planning, and management of pension and profit sharing plans. The Bank's business is not seasonal in nature. The Bank has no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Substantially all of the loans in the Bank's portfolio have been originated by the Bank. Policies adopted by the Board of Directors are the basis by which the Bank conducts its lending activities.

At December 31, 2015, the Bank had 177 full-time employees and 27 part-time employees. In the opinion of management, the Bank enjoys a satisfactory relationship with its employees. The Bank is not a party to any collective bargaining agreement.

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

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

Primary Market Areas

The Bank's primary market area reaches from Monroe and Montour counties along the Interstate 80 corridor through parts of Columbia and Luzerne counties as well as other adjoining counties. The Bank's eastern market area is centered in Stroudsburg, Pennsylvania and serves all of Monroe county, as well as adjoining counties of Pike and Northampton. The area served by the Bank is a mix of rural communities and small to mid-sized towns. The current population of the Bank's primary four-county footprint has increased 0.3% since 2011 to 570,000 and is estimated to decrease 0.9% to 565,000 by 2021. As of June 30, 2015, the FDIC deposit market share data ranked the Bank 5th in the deposit market share in the four-county market, with 7.1% of deposits.

The Bank's headquarters, main office, and three of its branch offices are located in Berwick, Pennsylvania. Therefore, the Bank has a very strong presence in the Borough of Berwick, a community with a current population of approximately 12,000. The Bank ranks a commanding first in deposit market share in the Berwick market with 71.1% of deposits as of June 30, 2015, based on data compiled annually by the FDIC.

In the course of attracting and retaining deposits and originating loans, the Bank faces considerable competition. The Bank competes with 25 commercial banks, 2 savings associations, 1 thrift, and 34 credit unions for traditional banking products, such as deposits and loans in its primary four-county market area. Additionally, the Bank competes with consumer finance companies for loans, mutual funds and other investment alternatives for deposits. The Bank competes for deposits based on the ability to provide a range of competitively priced products, quality service, competitive rates, and convenient locations and hours. The competition among its peers for loan origination generally relates to interest rates offered, products available, ease of process, quality of service, and loan origination fees charged. The economic base of the Bank's market region is developed around small business, health care, educational facilities (college and public schools), light manufacturing industries, and agriculture.

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

Competition - Bank

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

- First Columbia Bank & Trust Co.
- PNC Bank, N.A.
- M & T Bank
- FNB Bank, N.A.
- Wells Fargo Bank
- National Penn Bank
 - Citizens Savings Bank
- ESSA Bank & Trust

First National Community Bank
Service 1st FCU
Jersey Shore State Bank
Community Bank, N.A.
Valor FCU

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

Concentration

The Corporation and the Bank are not dependent on deposits nor exposed by loan concentrations to a single customer or to a small group of customers, such that the loss of any one or more would not have a materially adverse effect on the financial condition of the Corporation or the Bank. The customers' ability to repay their loans is generally dependent on the real estate market and general economic conditions prevailing in Pennsylvania, among other factors.

Supervision and Regulation

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

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

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

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

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

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

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

Permitted Non-Banking Activities

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

Legislation and Regulatory Changes

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

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

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

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

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

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 8%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 6%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under the FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category. On December 31, 2015, the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category. See Note 15 — Regulatory Matters.

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

Other Provisions of the FDICIA

Each depository institution must submit audited financial statements to its primary regulator and the FDIC, whose reports are made publicly available. In addition, the audit committee of each depository institution must consist of outside directors and the audit committee at “large institutions” (as defined by FDIC regulation) must include members with banking or financial management expertise. The audit committee at “large institutions” must also have access to independent outside counsel. In addition, an institution must notify the FDIC and the institution’s primary regulator of any change in the institution’s independent auditor, and annual management letters must be provided to the FDIC and the depository institution’s primary regulator. The regulations define a “large institution” as one with over \$500 million

in assets, which does include the Bank. Also, under the rule, an institution's independent public accountant must examine the institution's internal controls over financial reporting and perform agreed-upon procedures to test compliance with laws and regulations concerning safety and soundness.

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

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

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

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

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

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

Regulatory Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization’s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as business loans.

The following table presents the Bank’s capital ratios at December 31, 2015.

	(In Thousands)	
Tier I Capital	\$ 80,682	
Common Equity Tier 1 Capital	\$ 80,682	
Tier II Capital	\$ 6,923	
Total Capital	\$ 87,605	
Adjusted Total Average Assets	\$ 953,300	
Total Adjusted Risk-Weighted Assets ¹	\$ 636,890	
Tier I Risk-Based Capital Ratio ²	12.67	%
Required Tier I Risk-Based Capital Ratio	6.00	%
Excess Tier I Risk-Based Capital Ratio	6.67	%
Common Equity Tier 1 Risk-Based Capital Ratio ³	12.67	%
Required Common Equity Tier 1 Risk-Based Capital Ratio	4.50	%
Excess Common Equity Tier 1 Risk-Based Capital Ratio	8.17	%
Total Risk-Based Capital Ratio ⁴	13.76	%
Required Total Risk-Based Capital Ratio	8.00	%
Excess Total Risk-Based Capital Ratio	5.76	%

Tier I Leverage Ratio ⁵	8.46	%
Required Tier I Leverage Ratio	4.00	%
Excess Tier I Leverage Ratio	4.46	%

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

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

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

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

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

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

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

Regulatory Capital Changes

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

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

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

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

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010. The Corporation does not have trust preferred securities or cumulative perpetual preferred stock with no plans to add these to the capital structure.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets and certain deferred tax assets are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

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

Effect of Government Monetary Policies

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

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

Effects of Inflation

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

Environmental Regulation

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

Interest Rate Risk

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

JOBS Act

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

- Raising the threshold requiring registration under the Exchange Act for banks and bank holdings companies from 500 to 2,000 holders of record;

- Raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;

- Raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;

 - Permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;

- Allowing private companies to use "crowdfunding" to raise up to \$1 million in any 12-month period, subject to certain conditions; and

 - Creating a new category of issuer, called an "Emerging Growth Company," for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity initial public offering and complying with public company reporting obligations for up to five years.

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

The Gramm-Leach-Bliley Act of 1999

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

The Sarbanes-Oxley Act

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

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

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

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

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) became law in July 2010. Dodd-Frank is intended to affect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created a new Financial Stability Oversight Council to identify systemic risks in the financial system and gave federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally created a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank is expected to have a significant impact on our business operations as its provisions take effect. It is difficult to predict at this time what specific impact Dodd-Frank and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Among the provisions that are likely to affect us are the following:

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

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

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

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

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

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

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

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

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Available Information

The Corporation's common stock is registered under Section 12(g) of the Exchange Act. The Corporation is subject to the informational requirements of the Exchange Act, and, accordingly, files reports, proxy statements and other information with the SEC. The reports, proxy statements and other information filed with the SEC are available for inspection and copying at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Corporation is an electronic filer with the SEC. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC's internet site address is www.sec.gov.

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

ITEM 1A. RISK FACTORS

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

The Corporation is subject to interest rate risk.

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

quickly than the interest rates paid on deposits and other borrowings.

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

The Corporation is subject to lending risk.

As of December 31, 2015, approximately 66.6% of the Corporation's loan portfolio consisted of Commercial and Industrial loans and Commercial Real Estate loans (including construction loans) of which both include a tax-free component. These types of loans are generally viewed as having more risk of default than Residential Real Estate loans or Consumer loans. Commercial and Industrial and Commercial Real Estate loans are also typically larger than Residential Real Estate loans and Consumer loans. Because the Corporation's loan portfolio contains a significant number of Commercial and Industrial and Commercial Real Estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's financial condition and results of operations.

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

The Corporation's loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In determining the amount of the allowance for loan losses, the Corporation reviews its loans and loss and delinquency experience and evaluates economic conditions. If the Corporation's assumptions prove to be incorrect, the allowance for loan losses may not cover inherent losses in its loan portfolio at the date of the financial statement. Material additions to the Corporation's allowance would materially decrease net income. At December 31, 2015, the allowance for loan losses totaled \$6.7 million, representing 1.32% of average total loans.

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

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

The Corporation's operations of its business, including its interaction with customers, are increasingly done via electronic means, and this has increased risks related to cyber security.

The Corporation is exposed to the risk of cyber-attacks in the normal course of business. In general, cyber incidents can result from deliberate attacks or unintentional events. The Corporation has observed an increased level of attention in the industry focused on cyber-attacks that include, but are not limited to, gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. To combat against these attacks, the Corporation has policies and procedures in place to prevent or limit the effect of the possible security breach of its information systems and it has insurance against some cyber-risks and attacks. While the Corporation has not incurred any material losses related to cyber-attacks, nor is it aware of any specific or threatened cyber-incidents as of the date of this report, it may incur substantial costs and suffer other negative consequences if it falls victim to successful cyber-attacks. Such negative consequences could include remediation costs that may include liability for stolen assets or information and repairing system damage that may have been caused; deploying additional personnel and protection technologies, training employees, and engaging third party experts and consultants; lost revenues resulting from unauthorized use of proprietary information or the failure to retain or attract customers following an attack; disruption or failures of physical infrastructure, operating systems or

networks that support our business and customers resulting in the loss of customers and business opportunities; additional regulatory scrutiny and possible regulatory penalties; litigation; and reputational damage adversely affecting customer or investor confidence.

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

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

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

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

The Corporation operates in a highly competitive industry.

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

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

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

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

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

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

significant impact on the effectiveness of the Corporation's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation's business, results of operations and financial condition.

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

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

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

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

Future credit downgrades of the United States Government due to issues relating to debt and the deficit may adversely affect the Corporation.

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

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

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

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

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

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

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

The Corporation is subject to extensive government regulation and supervision.

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

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

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

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

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

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

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

The Corporation continually encounters technological change.

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

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

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

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

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

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

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

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

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

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

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

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

Poor economic conditions and the resulting bank failures have increased the costs of the FDIC and depleted its deposit insurance fund. Additional bank failures may prompt the FDIC to increase its premiums above the recently increased levels or to issue special assessments. The Corporation is generally unable to control the amount of premiums or special assessments that its subsidiary is required to pay for FDIC insurance. Any future changes in the calculation or assessment of FDIC insurance premiums may have a material adverse effect on the Corporation's results of operations, financial condition, and its ability to continue to pay dividends on its common stock at the current rate or at all.

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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

Properties owned are:

- Main Office located at 111 West Front Street, Berwick, Pennsylvania 18603;
 - Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;
 - Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
 - Scott Township Office located at 2301 Columbia Boulevard, Bloomsburg, Pennsylvania 17815;
 - Mifflinville Office located at Third and Race Streets, Mifflinville, Pennsylvania 18631;
 - Hanover Township Office located at 1540 Sans Souci Parkway, Hanover Township, Pennsylvania 18706;
 - Danville Office located at 1519 Bloom Road, Danville, Pennsylvania 17821;
 - Mountainhome Office located at 1154 Route 390, Cresco, Pennsylvania 18326;
 - Brodheads ville Office located at 2022 Route 209, Brodheads ville, Pennsylvania 18322;
 - Swiftwater Office located at 2070 Route 611, Swiftwater, Pennsylvania 18370;
 - Plymouth Office located at 463 West Main Street, Plymouth, Pennsylvania 18651;
 - Kingston Office located at 299 Wyoming Avenue, Kingston, Pennsylvania 18704;
 - Dallas Office located at 2325 Memorial Highway, Dallas, Pennsylvania 18612;
 - Shickshinny Office located at 107 South Main Street, Shickshinny, Pennsylvania 18655;
- Properties located at Second and Market Streets, and Third and Bowman Streets, Berwick, Pennsylvania 18603; and 20 ATMs located in Columbia, Luzerne, Montour and Monroe counties.

Properties leased are:

- Briar Creek Office located inside the Giant Market at 50 Briar Creek Plaza, Berwick, Pennsylvania 18603;
 - Nescopeck Office located at 437 West Third Street, Nescopeck, Pennsylvania 18635;
 - Stroudsburg Office located at 559 Main Street, Stroudsburg, Pennsylvania 18360; and
- Mountain Top Office located at 18 North Mountain Boulevard, Mountain Top, Pennsylvania 18707 (land parcel is leased and the bank building is owned).

ITEM 3. LEGAL PROCEEDINGS

The Corporation and/or the Bank are defendants in various legal proceedings arising in the ordinary course of their business. However, in the opinion of management of the Corporation and the Bank, there are no proceedings pending to which the Corporation and the Bank is a party or to which their property is subject, which, if determined adversely

to the Corporation and the Bank, would be material in relation to the Corporation's and Bank's individual profits or financial condition, nor are there any proceedings pending other than ordinary routine litigation incident to the business of the Corporation and the Bank. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation and the Bank by government authorities or others.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

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

- The quarterly high and low prices for a share of the Corporation's common stock during the periods indicated as reported to the management of the Corporation;
- Quarterly dividends on a share of the common stock paid with respect to each quarter since January 1, 2014; and
- The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

MARKET VALUE OF COMMON STOCK

2015	High	Low	Per Share Dividend Paid
First quarter	\$ 26.50	\$ 24.50	\$ 0.27
Second quarter	\$ 26.25	\$ 24.48	\$ 0.27
Third quarter	\$ 25.30	\$ 22.50	\$ 0.27
Fourth quarter	\$ 26.50	\$ 23.83	\$ 0.27

2014:

First quarter	\$ 27.00	\$ 24.24	\$ 0.26
Second quarter	\$ 26.25	\$ 24.05	\$ 0.26
Third quarter	\$ 25.00	\$ 24.00	\$ 0.26
Fourth quarter	\$ 24.70	\$ 23.05	\$ 0.27

As of December 31, 2015, the Corporation had approximately 927 shareholders of record.

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

dividends paid by the Bank to the Corporation. Therefore, the restrictions on the Bank's dividend payments are directly applicable to the Corporation.

Transfer Agent:

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

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

RBC Dain Rauscher (800) 223-4207
Janney Montgomery Scott LLC (800) 526-6397
Stifel Nicolaus & Co. Inc. (800) 223-6807
Boenning & Scattergood, Inc. (800) 883-1212
Monroe Securities, Inc. (312) 327-2530

Dividend Restrictions on the Bank

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

Dividend Restrictions on the Corporation

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

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

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

- Financial statements prepared on the basis of generally accepted accounting principles;
- Financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances; or

- A fair valuation or other method that is reasonable under the circumstances.

PERFORMANCE GRAPH

The following graph and table compare the cumulative total shareholder return on the Corporation’s common stock during the period December 31, 2010, through and including December 31, 2015, with:

The cumulative total return on the SNL Securities Corporate Performance Index¹ for banks \$500 million to \$1 billion in total assets in the Middle Atlantic area², and

- The cumulative total return for all United States stocks traded on the NASDAQ Stock Market.

The comparison assumes \$100 was invested on December 31, 2010, in the Corporation’s common stock and in each of the indices below and assumes further the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance.

FIRST KEYSTONE CORPORATION

	Period Ending					
	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
First Keystone Corporation	100.00	123.32	152.58	163.41	168.05	181.49
NASDAQ Composite	100.00	99.21	116.82	163.75	188.03	201.40
SNL Bank \$500M- \$1B	100.00	87.98	112.79	146.26	160.46	181.11

¹ SNL Securities is a research and publishing firm specializing in the collection and dissemination of data on the banking, thrift and financial services industries.

² The Middle Atlantic area comprises the states of Delaware, Pennsylvania, Maryland, New Jersey, New York, the District of Columbia and Puerto Rico.

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

	For the Year Ended December 31,					
	2015	2014	2013	2012	2011	
SELECTED FINANCIAL DATA AT YEAR END:						
Total assets	\$983,489	\$912,353	\$901,514	\$819,966	\$818,546	
Total investment securities	385,267	348,722	354,770	298,873	331,429	
Net loans	509,871	481,071	439,999	427,124	410,066	
Total deposits	720,598	661,562	690,075	608,834	624,349	
Total long-term borrowings	70,232	65,339	40,429	44,520	64,339	
Total stockholders' equity	108,438	106,271	96,351	103,330	93,092	
SELECTED OPERATING DATA:						
Interest income	\$31,711	\$31,019	\$30,961	\$34,936	\$37,028	
Interest expense	4,966	4,452	4,954	6,514	9,405	
Net interest income	26,745	26,567	26,007	28,422	27,623	
Provision for loan losses	2,277	433	1,372	1,600	1,900	
Net interest income after provision for loan losses	24,468	26,134	24,635	26,822	25,723	
Non-interest income	7,697	7,902	7,805	5,875	4,431	
Non-interest expense	21,022	21,208	19,942	20,521	17,695	
Income before income tax expense	11,143	12,828	12,498	12,176	12,459	
Income tax expense	1,971	2,617	2,225	2,006	2,552	
Net income	\$9,172	\$10,211	\$10,273	\$10,170	\$9,907	
PER SHARE DATA:						
Net income	\$1.64	\$1.84	\$1.87	\$1.86	\$1.82	
Dividends	1.08	1.05	1.04	1.01	0.97	
PERFORMANCE RATIOS:						
Return on average assets	0.96	% 1.13	% 1.23	% 1.25	% 1.21	%
Return on average equity	8.43	% 9.90	% 10.12	% 10.19	% 11.57	%
Dividend payout	65.79	% 56.95	% 55.64	% 54.18	% 53.31	%
Average equity to average assets	11.40	% 11.45	% 12.10	% 12.28	% 10.43	%

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

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

RESULTS OF OPERATIONS

Year Ended December 31, 2015 Versus Year Ended December 31, 2014

Net income decreased to \$9,172,000 for the year ended December 31, 2015, as compared to \$10,211,000 for the prior year, a decrease of 10.2%. Earnings per share, both basic and diluted, for 2015 was \$1.64 as compared to \$1.84 in 2014, a decrease of 10.9%. Dividends per share increased to \$1.08 in 2015 from \$1.05 in 2014, an increase of 2.9%. The Corporation's return on average assets was 0.96% in 2015 as compared to 1.13% in 2014. Return on average equity decreased to 8.43% in 2015 from 9.90% in 2014. Total interest income in 2015 amounted to \$31,711,000, an increase of \$692,000 or 2.2% from 2014. Total interest expense of \$4,966,000 increased \$514,000 or 11.5% from 2014. The majority of this increase related to interest expense on deposits as total interest bearing deposits increased from \$565,032,000 in 2014 to \$613,207,000 in 2015.

Net interest income, as indicated below in Table 1, increased by \$178,000 or 0.7% to \$26,745,000 for the year ended December 31, 2015. The Corporation's net interest income on a fully tax equivalent basis increased by \$503,000, or 1.8% to \$28,847,000 in 2015 as compared to \$28,344,000 in 2014.

Year Ended December 31, 2014 Versus Year Ended December 31, 2013

Net income decreased to \$10,211,000 for the year ended December 31, 2014, as compared to \$10,273,000 for the prior year, a decrease of 0.6%. Earnings per share, both basic and diluted, for 2014 was \$1.84 as compared to \$1.87 in 2013, a decrease of 1.6%. Dividends per share increased to \$1.05 in 2014 from \$1.04 in 2013, an increase of 1.0%. The Corporation's return on average assets was 1.13% in 2014 as compared to 1.23% in 2013. Return on average equity decreased to 9.90% in 2014 from 10.12% in 2013. Total interest income in 2014 amounted to \$31,019,000 as compared to \$30,961,000 in 2013. Total interest expense of \$4,452,000 decreased \$502,000 or 10.1% from 2013. The majority of this decrease related to interest expense on deposits as total interest bearing deposits declined from \$604,919,000 in 2013 to \$565,032,000 in 2014.

Net interest income, as indicated below in Table 1, increased by \$560,000 or 2.2% to \$26,567,000 for the year ended December 31, 2014. The Corporation's net interest income on a fully tax equivalent basis decreased by \$53,000, or 0.2% to \$28,344,000 in 2014 as compared to \$28,397,000 in 2013.

Table 1 — Net Interest Income

(Dollars in thousands)	2015/2014			2014/2013			
	Increase/(Decrease)			Increase/(Decrease)			
	2015	Amount	%	2014	Amount	%	2013
Interest Income	\$31,711	\$ 692	2.2	\$31,019	\$58	0.2	\$30,961
Interest Expense	4,966	514	11.5	4,452	(502)	(10.1)	4,954
Net Interest Income	26,745	178	0.7	26,567	560	2.2	26,007
Tax Equivalent Adjustment	2,102	325	18.3	1,777	(613)	(25.6)	2,390
Net Interest Income (fully tax equivalent)	\$28,847	\$ 503	1.8	\$28,344	\$(53)	(0.2)	\$28,397

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

	2015			2014			2013		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Interest Earning Assets:									
Loans:									
Commercial, net ^{1,2}	\$82,591	\$2,814	3.41 %	\$65,012	\$2,685	4.13 %	\$57,928	\$2,733	4.72 %
Real Estate ¹	421,578	18,259	4.33 %	398,179	17,507	4.40 %	372,225	17,339	4.66 %
Consumer, net ^{1,2}	5,436	441	8.11 %	5,279	383	7.26 %	5,887	426	7.24 %
Fees on Loans		629	0 %		552	0 %		583	0 %
Total Loans ³	509,605	22,143	4.35 %	468,470	21,127	4.51 %	436,040	21,081	4.83 %
Investment Securities:									
Taxable	258,320	6,526	2.53 %	282,145	7,850	2.78 %	226,465	6,903	3.05 %
Tax-Exempt ¹	105,974	4,697	4.43 %	68,062	3,561	5.23 %	91,074	5,314	5.83 %
Total Investment Securities	364,294	11,223	3.08 %	350,207	11,411	3.26 %	317,539	12,217	3.85 %
Restricted Investment in Bank Stocks	5,767	415	7.20 %	5,836	252	4.32 %	4,088	35	0.86 %
Interest-Bearing Deposits in Other Banks	2,226	32	1.44 %	1,170	6	0.51 %	8,029	18	0.22 %
Total Other Interest Earning Assets	7,993	447	5.59 %	7,006	258	3.68 %	12,117	53	0.44 %
Total Interest Earning Assets	881,892	33,813	3.83 %	825,683	32,796	3.97 %	765,696	33,351	4.36 %
Non-Interest Earning Assets:									
Cash and Due From Banks	7,648			7,687			6,917		
Allowance for Loan Losses	(6,694)			(6,483)			(5,971)		
Premises and Equipment	20,426			21,252			20,547		
Other Assets	51,321			52,813			51,371		
Total Non-Interest Earning Assets	72,701			75,269			72,864		
Total Assets	\$954,593			\$900,952			\$838,560		
Interest Bearing Liabilities:									
Savings, NOW Accounts, and Money	\$391,179	\$926	0.24 %	\$362,219	\$728	0.20 %	\$317,477	\$691	0.22 %

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Markets									
Time Deposits	192,177	2,232	1.16 %	204,024	2,226	1.09 %	251,758	2,932	1.16 %
Securities Sold U/A to Repurchase	21,221	53	0.25 %	16,936	40	0.24 %	18,753	78	0.42 %
Short-Term Borrowings	60,549	212	0.35 %	58,519	174	0.30 %	11,050	27	0.24 %
Long-Term Borrowings	69,837	1,543	2.21 %	54,331	1,284	2.36 %	45,493	1,226	2.69 %
Federal Funds Purchased			0 %	2		0 %			0 %
Total Interest Bearing Liabilities	734,963	4,966	0.68 %	696,031	4,452	0.64 %	644,531	4,954	0.77 %
Non-Interest Bearing Liabilities:									
Demand Deposits	101,063			92,454			80,833		
Other Liabilities	9,725			9,350			11,692		
Stockholders' Equity	108,842			103,117			101,504		
Total Liabilities/Stockholders' Equity	\$954,593			\$900,952			\$838,560		
Net Interest Income Tax Equivalent									
		\$28,847			\$28,344			\$28,397	
Net Interest Spread									
			3.15 %			3.33 %			3.59 %
Net Interest Margin									
			3.27 %			3.43 %			3.71 %

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

²Installment loans are stated net of unearned interest.

³Average loan balances include non-accrual loans. Interest income on non-accrual loans is not included.

NET INTEREST INCOME

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

Table 2 on the preceding page provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and interest expense as well as average tax equivalent rates earned and paid as of year-end 2015, 2014 and 2013.

The yield on earning assets was 3.83% in 2015, 3.97% in 2014, and 4.36% in 2013. The rate paid on interest bearing liabilities was 0.68% in 2015, 0.64% in 2014, and 0.77% in 2013. This resulted in a decrease in our net interest spread to 3.15% in 2015, as compared to 3.33% in 2014 and 3.59% in 2013.

As Table 2 illustrates, net interest margin, which is interest income less interest expense divided by average earning assets, was 3.27% in 2015 as compared to 3.43% in 2014 and 3.71% in 2013. Net interest margins are presented on a tax-equivalent basis. In 2015, yield on earning assets decreased by 0.14%, from 3.97% to 3.83% while the rate paid on interest bearing liabilities increased 0.04%. As investments were sold, matured or called, the principal balances were reinvested at lower, current rates. This was the primary cause of the lower yield on investments. Savings, NOW and money market interest expense increased as a result of the nationally branded Kasasa suite of high interest rewards checking and savings accounts. Average long-term borrowings increased \$15,506,000 while the average rate paid on these borrowings decreased by 0.15% from 2.36% to 2.21%. Therefore, the net interest spread and margin in 2015 as compared to 2014 was negatively impacted. Interest income exempt from federal tax was \$4,203,000 in 2015, \$3,520,000 in 2014, and \$4,743,000 in 2013. Interest income exempt from federal tax increased due to purchases of tax-exempt securities. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34%.

The decline in our net interest margin came from slightly lower earning asset yields in 2015 and 2014. Fully tax equivalent net interest income increased from 2014 to 2015 by \$503,000 or 1.8% to \$28,847,000. This occurred while the level of average earning assets increased by 6.8%. The Corporation's net interest margin was under pressure when interest rates started to rise since the Corporation continues to be liability sensitive. There will be more liabilities, including deposits, repricing than earning assets (loans and investments). To negate the potential impact of a lesser net interest margin, the Corporation will continue to focus on attracting lower cost checking, savings and money market accounts and reduce somewhat its dependence on higher priced certificates of deposit.

In December 2015, the Federal Reserve increased the federal-funds rate from near zero to between 0.25% and 0.50%. The initial impact to the Bank's net interest margin has been minimal. Short-term borrowing costs have increased in a similar fashion. However, there has been little to no change in deposit funding costs. Among assets, only very short asset yields have increased. In addition, a slight decrease in long-term asset yields has occurred while credit spreads have widened. As 2016 unfolds, the Bank will monitor short-term interest rate increases by the Federal Reserve as well as the position and slope of the yield curve. A steady and continued path of rising interest rates will have an initial negative effect on net interest margin, based on our asset/liability management model. However, indications are that higher interest rates, accompanied by a positively sloped yield curve would serve to increase our net interest margin in the long-term.

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

In 2015, the increase in net interest income on a fully tax equivalent basis of \$503,000 resulted from an increase in volume of \$2,867,000 and a decrease of \$2,364,000 due to changes in rate. In 2014, the decrease in net interest income on a fully tax equivalent basis of \$53,000 resulted from an increase in volume of \$2,035,000 and a decrease of \$2,088,000 due to changes in rate.

Table 3 — Rate/Volume Analysis

(Dollars in thousands)	2015 COMPARED TO 2014			2014 COMPARED TO 2013		
	VOLUME	RATE	NET	VOLUME	RATE	NET
Interest Income:						
Loans, Net	\$1,855	\$(839)	\$1,016	\$1,568	\$(1,522)	\$46
Taxable Investment Securities	(663)	(661)	(1,324)	1,697	(750)	947
Tax-Exempt Investment Securities	1,984	(848)	1,136	(1,343)	(410)	(1,753)
Restricted Investment in Bank Stocks	(3)	166	163	15	202	217
Other	5	21	26	(15)	3	(12)
Total Interest Income	\$3,178	\$(2,161)	\$1,017	\$1,922	\$(2,477)	\$(555)
Interest Expense:						
Savings, NOW and Money Markets	\$58	\$140	\$198	\$97	\$(60)	\$37
Time Deposits	(129)	135	6	(556)	(150)	(706)
Securities Sold U/A to Repurchase	10	3	13	(8)	(30)	(38)
Short-Term Borrowings	6	32	38	116	31	147
Long-Term Borrowings	366	(107)	259	238	(180)	58
Total Interest Expense	311	203	514	(113)	(389)	(502)
Net Interest Income	\$2,867	\$(2,364)	\$503	\$2,035	\$(2,088)	\$(53)

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

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2015, the provision for loan losses was \$2,277,000 as compared to \$433,000 for 2014 and \$1,372,000 for 2013. The provision in 2015 increased due to the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, economic conditions, other relevant factors, and a significant charge-off of \$1,355,000, as discussed below and in the Allowance For Loan Losses section on page 34. Net charge-offs by the Corporation for the fiscal years ended December 31, 2015, 2014 and 2013 were \$1,928,000, \$562,000, and \$625,000, respectively. See Allowance for Loan Losses on Page 34 for further discussion.

Gross charge-offs increased to \$2,016,000 at December 31, 2015, as compared to \$691,000 at December 31, 2014 and \$694,000 at December 31, 2013. The significant increase from 2014 to 2015 was due to a large charge-off in the amount of \$1,355,000 on a Commercial Real Estate loan to a student housing holding company. The loan was moved to non-accrual status during the third quarter of 2015 due to uncertainty regarding the collectability of principal and interest based on the borrower's failure to achieve stabilization and meet projected occupancy rates. The charge-off was completed during the fourth quarter of 2015 because the underlying value of the collateral supporting the loan was not sufficient to cover the loan balance. At that time, the loan was charged down to the estimated value of the supporting collateral less costs to sell. The large charge-off also contributed to the increase in net charge-offs and provision for loan losses in 2015 as compared to 2014 and 2013, but does not indicate a significant change in asset quality in the overall loan portfolio. See Table 10 – Analysis of Allowance for Loan Losses for further details.

The allowance for loan losses as a percentage of average loans outstanding was 1.32% as of December 31, 2015, 1.36% as of December 31, 2014 and 1.49% as of December 31, 2013.

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

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

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

NON-INTEREST INCOME

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

Non-interest income through December 31, 2015 was \$7,697,000, a decrease of 2.6%, or \$205,000, from 2014. Table 4 provides the major categories of non-interest income and each respective change comparing the last three years. The majority of the 2015 decrease was due to a decrease in net investment securities gains.

During 2015, the Corporation recorded a net gain of \$2,131,000 from the sales of securities in its investment portfolio, a decrease of \$625,000 from 2014. The Bank has taken gains and losses in the portfolio, primarily in municipal securities, to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates. In 2014, gains totaled \$2,756,000, while in 2013 they were \$2,900,000. These gains resulted from the normal readjustment process within the portfolio.

Gains on sales of mortgage loans provided \$548,000 in 2015 as compared to \$284,000 in 2014 and \$618,000 in 2013 in income. The increase in gains on sales of mortgage loans in 2015 was due to a favorable rate environment for mortgage lending. In 2015, the Bank originated \$36,939,000 in residential mortgage loans, of which \$18,251,000 were originated with the intent to sell. This compared favorably to 2014 when the Bank originated \$30,348,000 in residential mortgage loans, of which \$12,141,000 were originated with the intent to sell. The Corporation continues to service the majority of mortgages which are sold. This servicing income provides an additional source of non-interest income on an ongoing basis.

Service charges and fees increased by \$159,000 in 2015 as compared to 2014, or 9.9% due to an increase in per item overdraft fees and certain other deposit account fees. In addition, ATM and debit card income increased \$101,000 or 9.0%. Service charges and fees increased \$212,000 in 2014 as compared to 2013, primarily due to an increase in per item overdraft fees and certain other deposit account fees implemented during the second and third quarters of 2014.

During 2014, the Bank evaluated competitor fees in the marketplace and determined that higher deposit fees could be supported.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit investment products, and miscellaneous fees, decreased \$30,000 or 5.7% in 2015 and increased \$167,000 or 46.8% in 2014.

Table 4 — Non-Interest Income

<i>(Dollars in thousands)</i>	2015/2014				2014/2013			
	Increase/(Decrease)				Increase/(Decrease)			
	2015	Amount	%	2014	Amount	%	2013	
Trust department	\$877	\$(44)	(4.8)	\$921	\$80	9.5	\$841	
Service charges and fees	1,773	159	9.9	1,614	212	15.1	1,402	
Bank owned life insurance income	664	(16)	(2.4)	680	(7)	(1.0)	687	
ATM and debit card income	1,224	101	9.0	1,123	123	12.3	1,000	
Gains on sales of mortgage loans	548	264	93.0	284	(334)	(54.0)	618	
Impairment charges on equity securities	(14)	(14)	N/A			N/A		
Other	494	(30)	(5.7)	524	167	46.8	357	
Subtotal	5,566	420	8.2	5,146	241	4.9	4,905	
Net investment securities gains	2,131	(625)	22.7	2,756	(144)	(5.0)	2,900	
Total	\$7,697	\$(205)	2.6	\$7,902	\$97	1.2	\$7,805	

NON-INTEREST EXPENSE

Non-interest expense consists of salaries and employee benefits, occupancy, furniture and equipment, and other miscellaneous expenses. Table 5 provides the yearly non-interest expense by category, along with the amount, dollar changes, and percentage of change.

Total non-interest expense amounted to \$21,022,000, a decrease of \$186,000, or 0.9% in 2015 as compared to an increase of \$1,266,000, or 6.3% in 2014. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to 52.4% of total non-interest expense in 2015 and 54.1% in 2014. Salaries and employee benefits decreased \$463,000, or 4.0% in 2015 and increased \$546,000, or 5.0% in 2014. Reductions in salaries and employee benefits were achieved through changes implemented in staffing levels throughout the organization, although the Corporation experienced a 13.2% increase in medical insurance for its employees. The hiring of several new employees, and a full year of operations at the new Shickshinny branch, contributed to the 2014 increase in salaries and benefits expense. The number of full time equivalent employees was 189 as of December 31, 2015, 205 as of December 31, 2014, and 207 as of December 31, 2013.

Net occupancy expense decreased \$22,000, or 1.3% in 2015 as compared to an increase of \$154,000, or 10.1% in 2014. The 2014 increase in net occupancy expense primarily consisted of higher building depreciation, maintenance and repairs, and taxes associated with the new Dallas and Shickshinny branches and the renovation and expansion of the Bank's main headquarters. Furniture and equipment and computer expense decreased \$228,000, or 13.8% in 2015 compared to a decrease of \$46,000, or 2.7% in 2014. The decrease in 2015 was due to lower software maintenance costs as a result of the outsourcing of the Bank's core processing system. Pennsylvania shares tax expense increased \$77,000, or 12.1% in 2015 as a result of an increase in total assets and total equity. FDIC insurance expense increased \$27,000, or 5.3% in 2015 as compared to an increase of \$83,000, or 19.7% in 2014. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. Data processing fees of \$571,000 were incurred in 2015 as a result of the planned outsourcing of the Bank's core processing system for data security, disaster recovery and system efficiency goals. Foreclosed assets held for resale expense amounted to \$111,000 in 2015, \$80,000 in 2014 and \$41,000 in 2013. The Corporation incurred costs associated with the maintenance and sales of eight foreclosed properties in 2013 and 2014, and twelve properties in 2015. Advertising expenses decreased \$93,000 or 16.3% as a result of decreased digital media advertising expenses. FHLB prepayment penalties of \$345,000 were expenses related to the early prepayment of a borrowing with the Federal Home Loan Bank ("FHLB") in 2013. Other expenses increased \$198,000 or 6.4% from 2014 to 2015. The increase was due to higher fees for an enhanced internet and mobile banking platform and an increase in Kasasa rewards, including ATM surcharge funds, cash back on debit card purchases, and movie and music downloads.

The overall level of non-interest expense remains low, relative to the Bank's peers (community banks from \$500 million to \$1 billion in assets). In fact, the Bank's total non-interest expense was 2.20% of average assets in 2015 and 2.35% in 2014. The Bank's non-interest expense as a percentage of average assets places the Bank among the leaders in its peer financial institution categories in controlling non-interest expense.

Table 5 — Non-Interest Expense

(Dollars in thousands)	2015/2014				2014/2013			
	Increase/(Decrease)				Increase/(Decrease)			
	2015	Amount	%	2014	Amount	%	2013	
Salaries and employee benefits	\$11,012	\$ (463)	(4.0)	\$11,475	\$546	5.0	\$10,929	
Occupancy, net	1,655	(22)	(1.3)	1,677	154	10.1	1,523	
Furniture and equipment	602	17	2.9	585	(56)	(8.7)	641	
Computer expense	827	(245)	(22.9)	1,072	10	0.9	1,062	
Professional services	609	(6)	(1.0)	615	81	15.2	534	
Pennsylvania shares tax	712	77	12.1	635	(147)	(18.8)	782	
FDIC Insurance	532	27	5.3	505	83	19.7	422	
ATM and debit card fees	600	22	3.8	578	49	9.3	529	
Data processing fees	571	271	90.3	300	300	N/A		
Foreclosed assets held for resale	111	31	38.8	80	39	95.1	41	
Advertising	476	(93)	(16.3)	569	128	29.0	441	
FHLB prepayment penalties					(345)	(100.0)	345	
Other	3,315	198	6.4	3,117	424	15.7	2,693	
Total	\$21,022	\$ (186)	(0.9)	\$21,208	\$1,266	6.3	\$19,942	

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2015, was \$1,971,000 as compared to \$2,617,000 and \$2,225,000 for the years ended December 31, 2014 and 2013, respectively. The effective income tax rate was 17.7% in 2015, 20.4% in 2014, and 17.8% in 2013. The decrease in the effective tax rate for 2015 was due to an increase in tax-exempt interest earned from investments in state and local units of government. The increase in the effective tax rate for 2014 was due to sales of tax-free municipal securities during the past year and the reduction in the amount of tax credits from the low-income housing partnerships. The Corporation looks to maximize its tax-exempt income derived from both tax-free loans and tax-free municipal securities without triggering the alternative minimum tax. The Corporation does not expect a material change in its tax rate for 2016.

FINANCIAL CONDITION

GENERAL

Total assets increased to \$983,489,000 at year-end 2015, an increase of 7.8% from year-end 2014. Total assets as of December 31, 2014 were \$912,353,000, an increase of 1.2% over 2013.

Net loans increased in 2015 from \$481,071,000 to \$509,871,000, a 6.0% increase. Loan demand grew in 2015 as the Bank added loans in commercial and residential mortgage categories. Net loans in 2014 increased from 2013 by \$41,072,000 or 9.3%.

The cash surrender value of bank owned life insurance increased to \$21,900,000 at December 31, 2015, an increase of \$664,000 or 3.1% over 2014.

Investments in low-income housing partnerships were \$1,553,000 at year-end 2015, an increase of 37.4% from year-end 2014. The Bank became a limited partner in a new real estate venture during 2015 with an initial investment of \$590,000 and a commitment of an additional capital contribution up to \$1,514,000 over the life of the project. Investing in low-income housing real estate ventures enables the Bank to recognize tax credits and satisfy Community Reinvestment Act initiatives.

As of December 31, 2015, total deposits amounted to \$720,598,000, an increase of 8.9% from 2014, while total deposits as of year-end 2014 amounted to \$661,562,000, a decrease of 4.1% from 2013. The increase in 2015 was primarily due to the deposit of funds by a municipal depositor through normal, seasonal generation of tax revenues. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals, continue to be the Corporation's most significant source of funds.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Borrowings increased in 2015 and 2014 by \$12,309,000 and \$29,800,000, respectively, to fund loan growth.

Total stockholders' equity increased to \$108,438,000 at December 31, 2015, an increase of \$2,167,000 or 2.0% over 2014. Total stockholders' equity increased to \$106,271,000 at December 31, 2014, an increase of \$9,920,000 or 10.3% over 2013.

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 92.4% for 2015, compared to 91.6% for 2014 and 91.3% for 2013. 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.

INVESTMENT SECURITIES

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

The investment portfolio has been allocated between securities available-for-sale and securities held-to-maturity. No investment securities were established in a trading account. Available-for-sale securities increased \$37,575,000 or 10.8% to \$385,241,000 in 2015. Available-for-sale securities decreased \$6,032,000 or 1.7% to \$347,666,000 in 2014. At December 31, 2015, the net unrealized gain, net of the tax effect, on these securities was \$2,035,000 and was included in stockholders' equity as accumulated other comprehensive income. At December 31, 2015, the primary reason for the decrease in accumulated other comprehensive income was due to market value fluctuations. In 2015, held-to-maturity securities decreased \$1,030,000, or 97.5% to \$26,000 after decreasing \$16,000, or 1.5% in 2014. Table 6 provides data on the carrying value of the Corporation's investment portfolio on the dates indicated. The vast majority of investment security purchases are allocated as available-for-sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate an investment security.

The investment portfolio includes U.S. Treasury securities, U.S. Government corporations and agencies, corporate debt obligations, mortgage-backed securities, and obligations of state and political subdivisions, both tax-exempt and taxable. Marketable equity securities consists of common stock investments in other commercial banks and bank holding companies.

Securities available for sale may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on the Corporation's Consolidated Statements of Income. As of December 31, 2015, the investment portfolio does not contain any off-balance sheet derivatives or trust preferred investments.

Table 6 — Investment Securities*(Dollars in thousands)*

	December 31, 2015		2014		2013	
	Available for Sale ¹	Held to Maturity ²	Available for Sale ¹	Held to Maturity ²	Available for Sale ¹	Held to Maturity ²
U.S. Treasury securities	\$1,021	\$	\$11,378	\$	\$	\$
U. S. Government corporations and agencies	134,066	26	139,224	1,056	153,509	1,072
Obligations of state and political subdivisions	200,314		157,223		148,389	
Corporate debt securities	47,833		37,786		49,265	
Marketable equity securities	2,007		2,055		2,535	
Total	\$385,241	\$ 26	\$347,666	\$ 1,056	\$353,698	\$ 1,072

¹At fair value.²At amortized cost.

The amortized cost and weighted average yield of securities, by contractual maturity, are shown below at December 31, 2015. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Table 7 Securities Maturity Table

(Dollars in thousands)

	December 31, 2015				Held-To-Maturity	
	Available-For-Sale		Obligations		U.S. Government Corporations & Agencies	
	U.S. Treasury Securities	U.S. Government Corporations & Agencies Obligations ¹	of State & Political Subdivisions ²	Corporate Debt Securities	Marketable Equity Securities ³	Obligations ¹
Within 1 Year:						
Amortized cost	\$	\$	\$ 1,083	\$ 863	\$	\$
Weighted average yield			6.18	% 3.15	%	
1 - 5 Years:						
Amortized cost	1,022	19,246	32,037	12,065		26
Weighted average yield	0.96 %	1.82 %	% 2.89	% 2.30	%	2.55 %
5 - 10 Years:						
Amortized cost		41,219	81,407	36,234		
Weighted average yield		2.17	% 3.19	% 2.70	%	
After 10 Years:						
Amortized cost		74,936	80,770		1,194	
Weighted average yield		1.64	% 4.83	%	5.20	%
Total:						
Amortized cost	\$1,022	\$ 135,401	\$ 195,297	\$ 49,162	\$ 1,194	\$ 26
Weighted average yield	0.96 %	1.83 %	% 3.84	% 2.61	% 5.20	% 2.55 %

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

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

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

LOANS

Total loans increased to \$516,610,000 as of December 31, 2015, as compared to a balance of \$487,461,000 as of December 31, 2014. In 2015, the Corporation set aggressive asset growth goals to combat the challenging rate environment. Table 8 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans increased \$29,149,000, or 6.0% in 2015 compared to an increase of \$40,943,000, or 9.2% in 2014.

Increasing demand for borrowing by both individuals and businesses accounted for the 6.0% increase in the loan portfolio from December 31, 2014 to December 31, 2015. The Commercial and Industrial portfolio increased \$20,418,000 to \$85,074,000 as of December 31, 2015, as compared to \$64,656,000 at December 31, 2014. The increase in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling \$28,544,000 offset by loan payoffs of \$9,489,000, combined with utilization of existing lines of credit, offset by regular principal payments. The Commercial Real Estate loan portfolio increased \$5,096,000 to \$259,018,000 as of December 31, 2015, as compared to \$253,922,000 at December 31, 2014. The increase was mainly the result of \$47,529,000 in new loan originations, offset by \$19,697,000 in loan payoffs in addition to regular principal payments and other typical amortizations in the loan portfolio. Residential Real Estate loans increased \$3,075,000 to \$166,628,000 as of December 31, 2015, as compared to \$163,553,000 at December 31, 2014. The increase was the result of new loan originations totaling \$27,872,000, offset by loan payoffs of \$23,287,000 and net loans sold of \$5,301,000 combined with utilization of existing home equity lines of credit, offset by regular principal payments. Net loans sold in the Residential Real Estate portfolio for the year ended December 31, 2015 consisted of total loans sold during the year ended December 31, 2015 of \$19,243,000, offset with loans opened and sold in the same quarter during any quarter of 2015 which amounted to \$13,942,000. 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 \$344,092,000 at December 31, 2015. Of total loans, \$259,018,000 or 50.1% were secured by commercial real estate, primarily lessors of residential buildings and dwellings and lessors of non-residential buildings. We continue to monitor these portfolios.

The largest relationship is comprised of various real estate entities with a mutual owner who began real estate investment and development activities in 1989. The relationship had outstanding loan balances and unused commitments of \$10,938,000 at December 31, 2015. The individual owns a diverse mix of real estate entities which specialize in construction/development projects, leasing of commercial office space, and rental of multi-tenant residential units. This relationship is comprised of \$9,838,000 in long term debt and two lines of credit totaling \$1,100,000. The relationship is well secured by first lien mortgages on income producing commercial and residential real estate, plus the assignment of governmental leases and collateral pledge of cash accounts and marketable securities.

The second largest relationship consists of a hotel management company that has been in operation since 1987 and successfully owns and operates seven hotels. At December 31, 2015, the relationship consisted of outstanding loan balances and unused commitments totaling \$8,595,000. The debt is comprised of \$7,811,000 in long term debt and \$784,000 in available credit on two real estate term loans. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

The third 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 \$8,509,000 at December 31, 2015. The debt is comprised of \$7,792,000 in term debt, \$450,000 in lines of credit, and \$267,000 in available credit on a real estate term loan. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

The fourth largest relationship consists of a municipality founded in 1816 consisting of 35 square miles. The township completed a major expansion of its central sewage system in late 2012 due to increasing population growth among residential users and the addition of a large volume of business users, including pharmaceutical companies and recreational waterparks. The expansion was funded by grants, bond issues, and bank debt. At December 31, 2015, the relationship had outstanding balances of \$8,474,000, which consisted entirely of term debt. The loans are secured by project receivables and the full faith, credit, and taxing power of the township.

The fifth largest relationship is comprised of multiple first and second lien mortgages relating to the purchase and improvements of several existing hotels. The principal and related owners/guarantors have extensive experience in the hotel industry, owning and operating hotels in various states for over twenty-five years. At December 31, 2015, the

relationship had outstanding loan balances and unused commitments of \$8,090,000. The debt is comprised of \$8,035,000 in long term debt and two lines of credit totaling \$55,000. The loans are secured by commercial real estate and business assets.

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

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

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

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$492,730,000 or 95.5% of gross loans are graded Pass; \$9,777,000 or 1.9% are graded Special Mention; \$13,487,000 or 2.6% are graded Substandard; and \$0 are graded Doubtful. The rating is intended to represent the best assessment of risk available at a given point in time, based upon a review of the borrower's financial statements, credit analysis, payment history with the Bank, credit history and lender knowledge of the borrower. See Note 4 — Loans and Allowance for Loan Losses for risk grading tables.

Overall, non-pass grades increased to \$23,264,000 at December 31, 2015, as compared to \$18,738,000 at December 31, 2014. Commercial and Industrial non-pass grades increased to \$4,194,000 as of December 31, 2015, compared to \$68,000 as of December 31, 2014. Commercial Real Estate non-pass grades decreased to \$16,128,000 as of December 31, 2015 as compared to \$16,480,000 as of December 31, 2014. Residential Real Estate and Consumer non-pass grades increased to \$2,942,000 as of December 31, 2015, as compared to \$2,190,000 as of December 31, 2014.

The increase in Commercial and Industrial non-pass grades was mainly the result of the downgrade of three loans totaling \$4,158,000. All three loans are to a manufacturing company that produces parts for various industries. The loans were downgraded to Special Mention during the fourth quarter of 2015 due to declining revenues and uncertainty regarding future cash flows.

At December 31, 2015, Commercial Real Estate loans classified as Special Mention amounted to \$3,890,000 and Commercial Real Estate loans classified as Substandard amounted to \$12,238,000, as compared to December 31, 2014 when \$11,008,000 and \$5,472,000 in Commercial Real Estate loans were classified as Special Mention and Substandard, respectively. The large fluctuation in loans from Special Mention to Substandard from 2014 to 2015 is mainly the result of three large loans that were downgraded to substandard status during the year ended December 31, 2015. Two loans were to student housing holding companies totaling \$5,172,000 at December 31, 2015. The loans were downgraded from Special Mention to Substandard during 2015 due to the borrowers' failure to achieve stabilization and meet projected occupancy rates. One loan in the amount of \$3,172,000 is to a developer of a residential sub-division. The loan was downgraded from Special Mention to Substandard during 2015 because development plans were hindered and expected sales did not materialize.

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

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

Table 8 — Loans

(Dollars in thousands)	December 31,				
	2015	2014	2013	2012	2011
Commercial and Industrial	\$85,074	\$64,656	\$60,822	\$54,186	\$39,786
Commercial Real Estate	259,018	253,922	225,405	225,156	238,181
Residential Real Estate	166,628	163,553	154,675	147,168	130,851

Consumer	5,890	5,330	5,616	6,386	7,177
Total Loans	\$516,610	\$487,461	\$446,518	\$432,896	\$415,995

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

Table 9 Loan Maturity and Interest Sensitivity

Loans by Maturity

(Dollars in thousands)

	December 31, 2015			Total
	One Year and Less	Through Five Years	After Five Years	
Commercial and Industrial	\$17,174	\$ 27,364	\$ 40,536	\$85,074
Commercial Real Estate	37,522	91,349	130,147	259,018
Residential Real Estate	14,538	51,199	100,891	166,628
Consumer	1,623	3,443	824	5,890
Total	\$70,857	\$ 173,355	\$ 272,398	\$516,610

The above data represents the amount of loans receivable at December 31, 2015 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

Loans by Repricing Opportunity*(Dollars in thousands)*

	December 31, 2015			Total
	One Year and Less	After One Year Through Five Years	After Five Years	
Commercial and Industrial	\$33,414	\$ 37,440	\$ 14,220	\$85,074
Commercial Real Estate	60,155	187,928	10,935	259,018
Residential Real Estate	21,804	47,227	97,597	166,628
Consumer	2,877	2,993	20	5,890
Total	\$118,250	\$ 275,588	\$ 122,772	\$516,610
Loans with a fixed interest rate	\$51,421	\$ 82,423	\$ 113,373	\$247,217
Loans with a variable interest rate	66,829	193,165	9,399	269,393
Total	\$118,250	\$ 275,588	\$ 122,772	\$516,610

The above data represents the amount of loans receivable at December 31, 2015 which are due or have the opportunity to reprice in the periods indicated, based on remaining scheduled repayments of principal for fixed rate loans or date of next repricing opportunity for variable rate loans. The fixed and variable portions of the amounts of loans receivable due or repricing in the periods indicated are also summarized above.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2015, the allowance for loan losses was \$6,739,000 as compared to \$6,390,000 as of December 31, 2014. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

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

its regulatory supervisory authority.

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

Table 10 contains an analysis of the allowance for loan losses indicating charge-offs and recoveries by year. In 2015, net charge-offs as a percentage of average loans were 0.4% as compared to 0.1% in both 2014 and 2013. Net charge-offs amounted to \$1,928,000 in 2015, \$562,000 in 2014, and \$625,000 in 2013. During the year ended December 31, 2015, charge-offs increased primarily in the Commercial Real Estate portfolio due to a large charge-off on a loan to a student housing holding company completed during the three months ended December 31, 2015 in the amount of \$1,355,000. Charge-offs in the Commercial Real Estate category were \$1,759,000 in 2015 compared to \$328,000 and \$290,000 in 2014 and 2013, respectively. The Corporation's diligent collection efforts, fewer borrowers defaulting on credit obligations, and the improving economy contributed to the nominal balance in charge-offs in the Commercial Real Estate portfolio in 2014 and 2013. Excluding the \$1,355,000 charge-off on the loan to a student housing holding company, the minimal level of charge-offs in the Commercial Real Estate category would have continued into 2015, as the large charge-off was a deviation from the Bank's past charge-off activity.

For the year ended December 31, 2015, the provision for loan losses was \$2,277,000 as compared to \$433,000 for 2014 and \$1,372,000 for 2013. The net effect of the provision, charge-offs and recoveries increased the year-end allowance for loan losses to \$6,739,000 of which 10.8% was attributed to the Commercial and Industrial component, 59.1% attributed to the Commercial Real Estate component, 26.4% attributed to the Residential Real Estate component (primarily residential mortgages), 1.4% attributed to the Consumer component, and 2.3% being the unallocated component (refer to the activity in Note 4 – Loans and Allowance for Loan Losses on page 69). The Corporation determined that the provision for loan losses made during 2015 was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of December 31, 2015.

Table 10 — Analysis of Allowance for Loan Losses

(Dollars in thousands)	Years Ended December 31,				
	2015	2014	2013	2012	2011
Balance at beginning of period	\$6,390	\$6,519	\$5,772	\$5,929	\$5,701
Charge-offs:					
Commercial and Industrial	2	107	17	264	485
Commercial Real Estate	1,759	328	290	1,077	968
Residential Real Estate	210	209	348	404	218
Consumer	45	47	39	87	98
	2,016	691	694	1,832	1,769
Recoveries:					
Commercial and Industrial	22	31	24	23	28
Commercial Real Estate	59	81	31	22	51
Residential Real Estate	1	14	5	1	2
Consumer	6	3	9	29	16
	88	129	69	75	97
Net charge-offs	1,928	562	625	1,757	1,672
Additions charged to operations	2,277	433	1,372	1,600	1,900
Balance at end of period	\$6,739	\$6,390	\$6,519	\$5,772	\$5,929
Ratio of net charge-offs during the period to average loans outstanding during the period	0.4 %	0.1 %	0.1 %	0.4 %	0.4 %
Allowance for loan losses to average loans outstanding during the period	1.32 %	1.36 %	1.49 %	1.36 %	1.44 %

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 1.32% in 2015, 1.36% in 2014 and 1.49% in 2013.

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

Table 11 — Allocation of Allowance for Loan Losses

(Dollars in thousands)	December 31,									
	2015	%*	2014	%*	2013	%*	2012	%*	2011	%*
Commercial and Industrial	\$725	11.0	\$542	9.4	\$776	13.6	\$573	11.4	\$489	9.1
Commercial Real Estate	3,983	60.5	3,176	55.2	3,320	58.1	2,837	56.6	3,507	65.4
Residential Real Estate	1,777	27.0	1,928	33.5	1,565	27.4	1,524	30.4	1,228	22.9
Consumer	96	1.5	107	1.9	53	0.9	80	1.6	137	2.6
Unallocated	158	N/A	637	N/A	805	N/A	758	N/A	568	N/A
	\$6,739	100.0	\$6,390	100.0	\$6,519	100.0	\$5,772	100.0	\$5,929	100.0

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

NON-PERFORMING ASSETS

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

Total non-performing assets amounted to \$4,386,000 as of December 31, 2015, as compared to \$4,039,000 as of December 31, 2014. 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 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 \$2,748,000 as of December 31, 2015 as compared to \$3,974,000 as of

December 31, 2014. Foreclosed assets held for resale increased to \$1,472,000 as of December 31, 2015 from \$55,000 as of December 31, 2014. The significant increase in foreclosed assets held for resale and decrease in non-accrual loans is attributed to one property secured by commercial real estate valued at \$925,000 that was moved from non-accrual loans to foreclosed assets held for resale during the fourth quarter of 2015. Loans past-due 90 days or more and still accruing interest amounted to \$166,000 as of December 31, 2015 as compared to \$10,000 as of December 31, 2014. At December 31, 2015, loans past-due 90 days or more and still accruing interest consisted of two Residential Real Estate loans, which are deemed to be well secured by collateral and in the process of collection. Non-performing assets to total loans was 0.8% as of December 31, 2015 and December 31, 2014. Non-performing assets to total assets was 0.4% as of December 31, 2015 and December 31, 2014. The allowance for loan losses to total non-performing assets was 153.6% as of December 31, 2015 as compared to 158.2% as of December 31, 2014. Additional detail can be found in Table 12 – Non-Performing Assets and Impaired Loans and the Loans Receivable on Non-Accrual Status table in Note 4 – Loans and Allowance for Loan Losses. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Potential problem loans are defined as performing substandard loans which are not deemed to be impaired. These loans have characteristics that cause management to have doubts regarding the ability of the borrower to perform under present loan repayment terms and which may result in reporting these loans as non-performing loans in the future. Potential problem loans amounted to \$2,280,000 at December 31, 2015, \$2,477,000 at December 31, 2014 and \$1,183,000 at December 31, 2013.

Impaired loans were \$13,367,000 at December 31, 2015 and \$7,044,000 at December 31, 2014. The largest impaired loan relationship at December 31, 2015 consisted of one performing loan to a student housing holding company in the amount of \$4,204,000, 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 discounted cash flow evaluation at December 31, 2015 resulted in a specific allocation of \$309,000. At December 31, 2015, the second largest impaired loan relationship consisted of a performing loan to a developer of a residential sub-division in the amount of \$3,217,000, which was secured by commercial real estate. The contract was extended and the loan was modified as a TDR during the fourth quarter of 2015 because the weak real estate market has hindered the process of the development plans and expected sales of building lots have not materialized. The discounted cash flow evaluation at December 31, 2015 resulted in a specific allocation of \$0. The third largest impaired loan relationship at December 31, 2015 consisted of a non-performing originated participation loan to a student housing holding company which was secured by commercial real estate. The Corporation's participation share of the loan was \$968,000. 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. The collateral evaluation of the total participation at December 31, 2015 carried a value of \$2,615,000, after considering estimated appraisal adjustments and costs to sell of 17% and considering the total participation outstanding note balance, resulting in a specific allocation of \$0. The estimated appraisal adjustments and cost to sell percentages are determined based on the market area in which the real estate securing the loan is located, among other factors, and therefore, can differ from one loan to another. Of the \$13,367,000 in impaired loans at December 31, 2015, none were located outside the Corporation's primary market area.

Loans categorized as TDRs carried an unpaid balance of \$11,096,000 as of December 31, 2015 as compared to \$4,708,000 as of December 31, 2014. The increase was attributable to deterioration in the respective borrowers' financial position, and in some cases a declining collateral value, along with the Bank's proactive monitoring of the loan portfolio resulting in the identification of additional loans classified as TDRs. Of the twenty-eight restructured loans at December 31, 2015, four loans are classified in the Commercial and Industrial portfolio, twenty-three loans are classified in the Commercial Real Estate portfolio, and one loan is classified in the Consumer portfolio. At December 31, 2015, two Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$249,000 were not in compliance with the terms of their restructure, compared to December 31, 2014 when five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$2,087,000 were not in compliance with the terms of their restructure. The troubled debt restructurings at December 31, 2015 consisted of four interest rate modifications, eleven term modifications beyond the original stated term, and thirteen payment modifications. As of December 31, 2015, specific allocations of \$309,000 were attributable to the TDRs. There were \$41,000 and \$0 in unfunded commitments on TDRs at December 31, 2015 and 2014, respectively.

The significant increase in TDRs at December 31, 2015 as compared to December 31, 2014 is mainly due to the modification of two large loans as troubled debt restructurings during the year ended December 31, 2015. One loan in the amount of \$4,204,000 is to a student housing holding company. A payment modification was completed during the first quarter of 2015 due to the borrower's failure to achieve stabilization and meet projected occupancy rates. One loan in the amount of \$3,217,000 is to a developer of a residential sub-division. During the fourth quarter of 2015, a term modification was completed to extend the contract of the loan, because development plans were hindered and

expected sales of building lots have not materialized.

During the twelve months ended December 31, 2015, three Commercial Real Estate loans totaling \$4,382,000 that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same period in 2014 when one Consumer loan totaling \$4,000 and four Commercial Real Estate loans totaling \$188,000 that were modified as TDRs within the preceding twelve months had experienced payment defaults. The significant increase in defaulted TDRs at December 31, 2015 compared to December 31, 2014 is largely due to one loan in the amount of \$4,204,000 to a student housing holding company, which was modified as a TDR in the first quarter of 2015 and experienced its subsequent default during the second quarter of 2015.

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 2016. Excluding the assets disclosed in Table 12 – Non-Performing Assets and Impaired Loans and the Troubled Debt Restructurings section in Note 4 — Loans and Allowance for Loan Losses, management is not aware of any information about borrowers' possible credit problems which cause serious doubt as to their ability to comply with present loan repayment terms.

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

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

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2015, 2014, and 2013 management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 12 — Non-Performing Assets and Impaired Loans

(Dollars in thousands)	December 31,		
	2015	2014	2013
Non-performing assets			
Non-accrual loans	\$2,748	\$3,974	\$3,551
Foreclosed assets held for resale	1,472	55	480
Loans past-due 90 days or more and still accruing interest	166	10	318
Total non-performing assets	\$4,386	\$4,039	\$4,349
Impaired loans			
Non-accrual loans	\$2,748	\$3,974	\$3,551
Accruing TDRs	10,619	3,070	2,423
Total impaired loans	13,367	7,044	5,974
Allocated allowance for loan losses	(340)	(119)	(140)
Net investment in impaired loans	\$13,027	\$6,925	\$5,834
Impaired loans with a valuation allowance	\$4,640	\$1,086	\$275
Impaired loans without a valuation allowance	8,727	5,958	5,699
Total impaired loans	\$13,367	\$7,044	\$5,974
Allocated valuation allowance as a percent of impaired loans	2.5 %	1.7 %	2.3 %
Impaired loans to total loans	2.6 %	1.4 %	1.3 %
Non-performing assets to total loans	0.8 %	0.8 %	1.0 %
Non-performing assets to total assets	0.4 %	0.4 %	0.5 %
Allowance for loan losses to impaired loans	50.4 %	90.7 %	109.1 %
Allowance for loan losses to total non-performing assets	153.6 %	158.2 %	149.9 %

Real estate mortgages comprise 82.4% of the loan portfolio as of December 31, 2015, as compared to 85.6% as of December 31, 2014. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation's market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation's market area. The Corporation's loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

DEPOSITS AND OTHER BORROWED FUNDS

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

Deposits increased by \$59,036,000, or 8.9% for the year ending December 31, 2015. This increase compares favorably to a deposit decrease of \$28,513,000, or 4.1% in 2014. The increase in deposits in 2015 can be attributed to a significantly higher balance in one large municipal depositor's account as of December 31, 2015 when compared to December 31, 2014. The shift to core deposits and away from time deposits continued in 2015. Demand deposits and savings accounts increased, while certificates of deposits fell.

The following schedule reflects the remaining maturities of time deposits and other time deposits of \$100,000 or more at December 31, 2015.

(Dollars in thousands)	Time Deposits >\$100,000	Other Time Deposits >\$100,000
Less than or equal to 3 months	\$ 7,797	\$
Over 3 months through 6 months	5,413	
Over 6 months through 12 months	9,665	855
Over 12 months	42,442	
	\$ 65,317	\$ 855

Total borrowings were \$150,771,000 as of December 31, 2015, compared to \$138,462,000 on December 31, 2014. During 2015, long-term borrowings increased from \$65,339,000 to \$70,232,000. In 2014, long-term borrowings increased from \$40,429,000 to \$65,339,000. The increases in long-term borrowings occurred in order to sustain growth in the Bank's loan portfolio and to secure financing at low market rates. Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more.

Short-term borrowings were also used to sustain loan growth and to support higher levels of investments at year-end. Short-term debt increased from \$73,123,000 in 2014 to \$80,539,000 as of December 31, 2015. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window and short-term borrowings from FHLB. Short-term borrowings from FHLB are commonly used to offset seasonal fluctuations in deposits.

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

The following table shows information about the Corporation's short-term borrowings as of December 31, 2015 and 2014.

Table 13 Short-Term Borrowings

(Dollars in thousands)	2015			
	Month End Balance	Average Balance	Maximum Month End Balance	Average Rate
Federal funds purchased	\$	\$	\$	0.00 %
Securities sold under agreements to repurchase	20,779	21,221	25,260	0.25 %
Federal Discount Window				0.73 %
Federal Home Loan Bank	59,760	60,549	76,816	0.35 %
	\$80,539	\$81,770	\$102,076	0.32 %

(Dollars in thousands)	2014			
	Month End Balance	Average Balance	Maximum Month End Balance	Average Rate
Federal funds purchased	\$	\$2	\$	0.76 %
Securities sold under agreements to repurchase	16,730	16,936	18,908	0.24 %
Federal Discount Window		5		0.75 %
Federal Home Loan Bank	56,393	58,514	93,125	0.30 %
	\$73,123	\$75,457	\$112,033	0.28 %

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains or losses on investment securities available-for-sale, net of taxes, referred to as accumulated other comprehensive income (loss), may increase or decrease total equity capital. The total net increase in capital was \$2,167,000 in 2015 after an increase of \$9,920,000 in 2014. The increase in equity capital in 2015 was due to the retention of \$3,137,000 in earnings and the issuance of new shares through the Corporation's Dividend Reinvestment Program ("DRIP") amounting to \$1,286,000. Accumulated other comprehensive income decreased \$2,295,000 in 2015 as a result of market fluctuations in the investment portfolio. The increase in equity capital in 2014 was due to the retention of \$4,396,000 in earnings and an increase in accumulated other comprehensive income due to market fluctuations.

The Corporation had 233,112 shares of common stock as of December 31, 2015 and 235,149 shares of common stock as of December 31, 2014, at a cost of \$5,756,000 and \$5,823,000, respectively as treasury stock, authorized and issued but not outstanding.

Return on average equity ("ROE") is computed by dividing net income by average stockholders' equity. This ratio was 8.43% for 2015, 9.90% for 2014, and 10.12% for 2013. Refer to Performance Ratios on page 22 — Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 14 reflects risk-based capital ratios and the leverage ratio for the Bank. The Bank's leverage ratio was 8.46% at December 31, 2015 and 8.63% at December 31, 2014.

The Bank has consistently maintained regulatory capital ratios at or above the "well capitalized" standards. To be categorized as "well capitalized", the Bank must maintain minimum Tier 1 Risk-Based capital, Common Equity Tier 1 Risk Based Capital, Total Risk-Based capital and Tier 1 Leverage ratios of 8.0%, 6.5%, 10.0% and 5.0%, respectively. For additional information on capital ratios, see Note 15 — Regulatory Matters. As Table 14 indicates, the risk-based capital ratios for the Bank decreased over the prior year. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments.

Table 14 — Capital Ratios

	December 31,	
	2015	2014
Risk-Based Capital:		
Tier 1 risk-based capital ratio	12.67%	13.92%
Common Equity Tier 1 risk-based capital ratio	12.67%	N/A
Total risk-based capital ratio (Tier 1 and Tier 2)	13.76%	15.07%
Leverage Ratio:		
Tier 1 capital to average assets	8.46 %	8.63 %

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

LIQUIDITY MANAGEMENT

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as the operating cash needs of the Corporation, are met.

Liquidity is needed to provide the funding requirements of depositor's withdrawals, loan growth, and other operational needs. 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 the 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.

Management believes its current liquidity position is satisfactory given the fact that the Corporation has a very stable core deposit base which has increased annually. Secondly, the Corporation's loan payments and principal paydowns on its mortgage-backed securities provide a steady source of funds. Also, short-term investments and maturing investments represent additional sources of liquidity.

Finally, the Corporation's subsidiary bank does have access to funds on a short-term basis from the Federal Discount Window. Also, Fed Funds can be purchased by means of a borrowing line at the Atlantic Community Bankers Bank. The Corporation has indirect access to the capital markets through its membership in the Federal Home Loan Bank. Advances on borrowings, both short-term and long-term, are available to help address any liquidity needs.

Table 15 represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of December 31, 2015.

Table 15 — Contractual Obligations

(Dollars in thousands)

December 31, 2015	Less than 1 Year	1 - 3 Years	4 -5 Years	Over 5 Years	Total
Time deposits	\$79,545	\$49,918	\$52,470	\$3,773	\$185,706
Securities sold under agreement to repurchase	20,779				20,779
Short-term borrowings	59,760				59,760
Long-term borrowings	5,000	33,000	30,000	2,000	70,000
Operating lease obligations	125	266	169	2,589	3,149
Capital lease obligations	116	116			232
	\$165,325	\$83,300	\$82,639	\$8,362	\$339,626

Off-Balance Sheet Arrangements

The Corporation is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and, to a lesser extent, standby letters of credit. At December 31, 2015, the Corporation had unfunded outstanding commitments to extend credit of \$79,771,000 and outstanding standby letters of credit of \$5,167,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. Please refer to Note 16 — Financial Instruments with

Off-Balance Sheet Risk and Concentrations of Credit Risk for a discussion of the nature, business purpose, and importance of the Corporation's off-balance sheet arrangements.

MARKET RISK

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

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

Asset/Liability Management

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Table 16 presents an interest sensitivity analysis of assets and liabilities as of December 31, 2015. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 16 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (December 31, 2015 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive.

Table 16 — Interest Rate Sensitivity Analysis

(Dollars in thousands)

	December 31, 2015				Total
	One Year	1 - 5 Years	Beyond 5 Years	Not Rate Sensitive	
Assets	\$177,263	\$412,441	\$294,909	\$98,876	\$983,489
Liabilities/Stockholders' Equity	218,690	498,228	160,000	106,571	983,489
Interest Rate Sensitivity Gap	\$(41,427)	\$(85,787)	\$134,909	\$(7,695)	
Cumulative Gap	\$(41,427)	\$(127,214)	\$7,695		

Earnings at Risk

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

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

Earnings Simulation Modeling

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

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

Table 17 presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from various increases or decreases in the level of interest rates, such as two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease 5.6%, 11.7% and 18.3% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would decrease 1.3% and 7.3% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 25 – 50 basis point range. Results of the decreasing basis point declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the years 2015 and 2014, the cost of interest-bearing liabilities averaged 0.68% and 0.64%, respectively, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 3.83% and 3.97%, respectively.

Net Present Value Estimation

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At December 31, 2015, the 100 and 200 basis point immediate decreases in rates are estimated to affect tax-adjusted net present value with an increase of 2.0% and a decrease of 1.0%, respectively. Additionally, tax-adjusted net present value is projected to decrease 5.0%, 11.0%, and 17.4% in the 100, 200 and 300 basis point immediate increase scenarios, respectively. All scenarios presented are below 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 contemplate actions management could undertake in response to changes in interest rates.

Table 17 — Effect of Change in Interest Rates

Projected Change

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Effect on Net Interest Income

1-Year Net Income Simulation Projection

+300 bp Shock vs. Stable Rate	(18.3)%
+200 bp Shock vs. Stable Rate	(11.7)%
+100 bp Shock vs. Stable Rate	(5.6)%
Flat rate	0.0	%
100 bp Shock vs. Stable Rate	(1.3)%
200 bp Shock vs. Stable Rate	(7.3)%

Effect on Net Present Value of Balance Sheet

Static Net Present Value Change

+300 bp Shock vs. Stable Rate	(17.4)%
+200 bp Shock vs. Stable Rate	(11.0)%
+100 bp Shock vs. Stable Rate	(5.0)%
Flat rate	0.0	%
100 bp Shock vs. Stable Rate	2.0	%
200 bp Shock vs. Stable Rate	(1.0)%

Table 18 shows the quarterly results of operations for the Corporation for the years ended December 31, 2015 and 2014:

Table 18 — Quarterly Results of Operations (Unaudited)

(Dollars in thousands, except per share data)

2015	Three Months Ended			
	March 31	June 30	September 30	December 31
Interest income	\$7,909	\$7,857	\$ 7,885	\$ 8,060
Interest expense	1,192	1,229	1,254	1,291
Net interest income	6,717	6,628	6,631	6,769
Provision for loan losses	212	213	753	1,099
Non-interest income	1,857	1,993	2,432	1,415
Non-interest expense	5,283	5,396	5,232	5,111
Income before income tax expense	3,079	3,012	3,078	1,974
Income tax expense	630	582	593	166
Net income	\$2,449	\$2,430	\$ 2,485	\$ 1,808
Basic and diluted earnings per share	\$0.44	\$0.44	\$ 0.44	\$ 0.32

(Dollars in thousands, except per share data)

2014	Three Months Ended			
	March 31	June 30	September 30	December 31
Interest income	\$7,633	\$7,776	\$ 7,815	\$ 7,795
Interest expense	1,125	1,108	1,080	1,139
Net interest income	6,508	6,668	6,735	