FIRST KEYSTONE CORP
Form 10-K
March 18, 2019

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

or

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

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its Charter)

Pennsylvania	**23-2249083**
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification Number)
111 West Front Street Berwick, Pennsylvania	**18603**
(Address of principal executive offices)	(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 x

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 x

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 x No ¨

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

Yes x 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. x

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

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

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

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

Yes ¨ No x

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

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

DOCUMENTS INCORPORATED BY REFERENCE

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

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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 foreg or other variations thereon or comparable terminology, or by discussion of strategy.

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

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

ITEM 1. BUSINESS

General

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

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

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

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

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

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

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

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

Primary Market Areas

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

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

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

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

Competition - Bank

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

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

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

Concentration

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

Supervision and Regulation

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

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

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

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

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

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

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

Permitted Non-Banking Activities

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

Legislation and Regulatory Changes

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

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

Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA")

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

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

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

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

Other Provisions of the FDICIA

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

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

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

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

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

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

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

Regulatory Capital Requirements

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

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

	(Dollars In Thousands)	
Tier I Capital	$ 89,203	
Common Equity Tier 1 Capital	$ 89,203	
Tier II Capital	$ 6,862	
Total Capital	$ 96,065	
Adjusted Total Average Assets	$ 990,410	
Total Adjusted Risk-Weighted Assets[1]	$ 692,434	
Tier I Risk-Based Capital Ratio[2]	12.88	%
Required Tier I Risk-Based Capital Ratio (plus Capital Buffer)	7.88	%
Excess Tier I Risk-Based Capital Ratio	5.00	%
Common Equity Tier 1 Risk-Based Capital Ratio[3]	12.88	%

Required Common Equity Tier 1 Risk-Based Capital Ratio (plus Capital Buffer)	6.38	%
Excess Common Equity Tier 1 Risk-Based Capital Ratio	6.50	%
Total Risk-Based Capital Ratio[4]	13.87	%
Required Total Risk-Based Capital Ratio (plus Capital Buffer)	9.88	%
Excess Total Risk-Based Capital Ratio	3.99	%
Tier I Leverage Ratio[5]	9.01	%
Required Tier I Leverage Ratio	4.00	%
Excess Tier I Leverage Ratio	5.01	%

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

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

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

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

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

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

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

Regulatory Capital Changes

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

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

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

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

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

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

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

Effect of Government Monetary Policies

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

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

Effects of Inflation

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

Environmental Regulation

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

Interest Rate Risk

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

Tax Cuts and Jobs Act

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

JOBS Act

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

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

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

The Gramm-Leach-Bliley Act of 1999

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

The Sarbanes-Oxley Act

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

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

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

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

Dodd-Frank Wall Street Reform and Consumer Protection Act

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

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

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

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

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

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

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

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

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

Department of Defense Military Lending Rule

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

Available Information

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

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

ITEM 1A. RISK FACTORS

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

The Corporation is subject to interest rate risk.

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

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

The Corporation is subject to lending risk.

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

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

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

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

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

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

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

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

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

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

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

The Corporation operates in a highly competitive industry.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Corporation is subject to extensive government regulation and supervision.

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

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

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

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

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

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

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

The Corporation continually encounters technological change.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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

Properties owned are:

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

Properties leased are:

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

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

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

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

MARKET VALUE OF COMMON STOCK

2018	High	Low	Per Share Dividend Paid
First quarter	$ 28.75	$ 26.01	$ 0.27
Second quarter	$ 28.99	$ 26.25	$ 0.27
Third quarter	$ 27.00	$ 25.11	$ 0.27
Fourth quarter	$ 26.50	$ 20.31	$ 0.27

2017	High	Low	Dividend Paid
First quarter	$26.50	$24.25	$ 0.27
Second quarter	$27.65	$25.01	$ 0.27
Third quarter	$28.25	$26.50	$ 0.27
Fourth quarter	$29.30	$27.00	$ 0.27

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

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

Transfer Agent:

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

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

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

Dividend Restrictions on the Bank

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

Dividend Restrictions on the Corporation

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

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

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

- Financial statements prepared on the basis of generally accepted accounting principles;
-

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

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

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

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

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

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

RESULTS OF OPERATIONS

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

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

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

Table 1 — Reconciliation of Taxable Equivalent Net Interest Income

(Dollars in thousands)		2018/2017 Increase/(Decrease)		
	2018	Amount	%	2017
Interest Income	$35,573	$3,305	10.2	$32,268
Interest Expense	8,620	2,072	31.6	6,548
Net Interest Income	26,953	1,233	4.8	25,720

Tax Equivalent Adjustment	2,621	(279)	(9.6)	2,900
Net Interest Income (fully tax equivalent)	$29,574	$954	3.3	$28,620

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Table 2 — Average Balances, Rates and Interest Income and Expense

(Dollars in thousands)

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

Net Interest Income Tax Equivalent	$29,574	$28,620
Net Interest Spread	2.98 %	2.93 %
Net Interest Margin	3.18 %	3.09 %

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

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

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

[4]Installment loans are stated net of unearned interest.

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

NET INTEREST INCOME

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

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

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

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

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

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

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

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

Table 3 — Rate/Volume Analysis

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

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

PROVISION FOR LOAN LOSSES

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

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

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

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

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

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

NON-INTEREST INCOME

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

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

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

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

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

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

Table 4 — Non-Interest Income

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

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NON-INTEREST EXPENSE

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

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

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

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

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

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

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

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

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

Table 5 — Non-Interest Expense

(Dollars in thousands)

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

INCOME TAX EXPENSE

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

FINANCIAL CONDITION

GENERAL

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

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

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

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

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

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

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

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

SEGMENT REPORTING

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

EARNING ASSETS

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

SECURITIES

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

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

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

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

Table 6 — Securities

(Dollars in thousands)

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

The amortized cost and weighted average yield of securities, by contractual maturity, are shown below at December 31, 2018. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Table 7 Securities Maturity Table

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

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

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

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

LOANS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 8 — Loans

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

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

Table 9 Loan Maturity and Interest Sensitivity

Loans by Maturity

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

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

Loans by Repricing Opportunity

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

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

ALLOWANCE FOR LOAN LOSSES

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

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

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

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

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

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

Table 10 — Analysis of Allowance for Loan Losses

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

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

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

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

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

Table 11 — Allocation of Allowance for Loan Losses

(Dollars in thousands)	December 31,									
	2018	%*	2017	%*	2016	%*	2015	%*	2014	%*
Commercial and Industrial	$724	11.7	$949	14.0	$836	11.7	$725	11.0	$542	9.4
Commercial Real Estate	3,700	59.8	4,067	60.0	4,421	62.0	3,983	60.5	3,176	55.2
Residential Real Estate	1,650	26.6	1,656	24.4	1,777	24.9	1,777	27.0	1,928	33.5
Consumer	117	1.9	111	1.6	95	1.4	96	1.5	107	1.9
Unallocated	554	**N/A**	704	N/A	228	N/A	158	N/A	637	N/A
	$6,745	100.0	$7,487	100.0	$7,357	100.0	$6,739	100.0	$6,390	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 deferments and extensions of maturity dates at a stated interest rate lower than the current market for a new loan with similar risk characteristics. While unusual, there may be instances of loan principal forgiveness. Foreclosed assets held for resale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 12 — Non-Performing Assets and Impaired Loans

(Dollars in thousands)	December 31,	
	2018	2017
Non-performing assets		
Non-accrual loans	$3,896	$5,090

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

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

DEPOSITS AND OTHER BORROWED FUNDS

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

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

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

(Dollars in thousands)	Time Deposits >$100,000	Other Time Open Deposits >$100,000
Less than or equal to 3 months	$ 7,186	$
Over 3 months through 6 months	10,924	
Over 6 months through 12 months	25,719	855
Over 12 months	38,217	
	$ 82,046	$ 855

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

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

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

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

Table 13 Short-Term Borrowings

(Dollars in thousands)	2018				
	Month End Balance	Average Balance	Maximum Month End Balance	Average Rate	
Federal funds purchased	$	$	$	2.19	%
Securities sold under agreements to repurchase	12,957	15,481	19,225	0.56	%
Federal Discount Window				2.19	%
Federal Home Loan Bank	161,488	96,120	161,487	2.28	%
	$174,445	$111,601	$ 180,712	2.04	%

(Dollars in thousands)	2017				
	Month End Balance	Average Balance	Maximum Month End Balance	Average Rate	
Federal funds purchased	$	$	$	1.82	%
Securities sold under agreements to repurchase	22,844	21,872	23,452	0.41	%
Federal Discount Window		10		1.71	%
Federal Home Loan Bank	3,452	64,830	115,445	1.16	%
	$26,296	$86,712	$138,897	0.97	%

CAPITAL STRENGTH

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

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

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

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

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

Table 14 — Capital Ratios

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

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

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

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

LIQUIDITY MANAGEMENT

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

Sources of liquidity are as follows:

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

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

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

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

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

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

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

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

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

Table 15 — Contractual Obligations

(Dollars in thousands)

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

Off-Balance Sheet Arrangements

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

MARKET RISK

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

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

Asset/Liability Management

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

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

Table 16 — Interest Rate Sensitivity Analysis

(Dollars in thousands)

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

Earnings at Risk

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

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

Earnings Simulation Modeling

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

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

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

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

Net Present Value Estimation

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

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

Table 17 — Effect of Change in Interest Rates

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

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

Table 18 — Quarterly Results of Operations (Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended			
2018	March 31	June 30	September 30	December 31
Interest income	$8,271	$8,737	$ 9,169	$ 9,396
Interest expense	1,781	1,984	2,284	2,571
Net interest income	6,490	6,753	6,885	6,825
Provision for loan losses	50			150
Non-interest income	1,259	1,470	1,502	1,331
Non-interest expense	5,895	5,676	5,607	