

FIRST KEYSTONE CORP  
Form 10-Q  
August 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the quarterly period ended June 30, 2016

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**

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(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

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

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

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

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

Yes  No

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

Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

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

Yes  No

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

Common Stock, \$2 Par Value, 5,645,997 shares as of August 3, 2016

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollars in thousands, except per share data)

|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Cash and due from banks   | \$8,586          | \$ 7,474             |
| Interest-bearing deposits in other banks                                    | 672              | 1,534                |
| Total cash and cash equivalents   | 9,258            | 9,008                |
| Time deposits with other banks  | 1,482            | 1,482                |
| Investment securities available-for-sale                                    | 385,089          | 385,241              |
| Investment securities held-to-maturity (fair value 2016- \$21; 2015 - \$27) | 20               | 26                   |
| Restricted investment in bank stocks  | 6,622            | 5,742                |
| Loans   | 516,998          | 516,610              |
| Allowance for loan losses   | (7,219 )         | (6,739 )             |
| Net loans   | 509,779          | 509,871              |
| Premises and equipment, net   | 19,697           | 20,113               |
| Accrued interest receivable   | 3,932            | 4,086                |
| Cash surrender value of bank owned life insurance                           | 22,229           | 21,900               |
| Investments in low-income housing partnerships                              | 1,465            | 1,553                |
| Goodwill  | 19,133           | 19,133               |
| Foreclosed assets held for resale   | 1,280            | 1,472                |
| Deferred income taxes   |                  | 692                  |
| Other assets  | 3,330            | 3,170                |
| <b>TOTAL ASSETS</b>   | <b>\$983,316</b> | <b>\$ 983,489</b>    |
| <b>LIABILITIES</b>  |                  |                      |
| Deposits:   |                  |                      |
| Non-interest bearing  | \$109,113        | \$ 107,391           |
| Interest bearing  | 575,358          | 613,207              |
| Total deposits  | 684,471          | 720,598              |
| Short-term borrowings   | 99,638           | 80,539               |
| Long-term borrowings  | 75,175           | 70,232               |
| Accrued interest payable  | 441              | 382                  |
| Deferred income taxes   | 2,709            |                      |
| Other liabilities   | 3,546            | 3,300                |
| <b>TOTAL LIABILITIES</b>  | <b>865,980</b>   | <b>875,051</b>       |

STOCKHOLDERS' EQUITY

|  |           |            |
|--|-----------|------------|
| Preferred stock, par value \$2.00 per share; authorized 1,000,000 shares in 2016 and 2015; issued 0 in 2016 and 2015   |           |            |
| Common stock, par value \$2.00 per share; authorized 20,000,000 shares in 2016 and 2015; issued 5,879,109 in 2016 and 5,853,317 in 2015; outstanding 5,645,997 in 2016 and 5,620,205 in 2015 | 11,758    | 11,707     |
| Surplus  | 34,450    | 33,830     |
| Retained earnings  | 68,251    | 66,622     |
| Accumulated other comprehensive income   | 8,633     | 2,035      |
| Treasury stock, at cost, 233,112 shares in 2016 and 2015   | (5,756 )  | (5,756 )   |
| TOTAL STOCKHOLDERS' EQUITY   | 117,336   | 108,438    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY   | \$983,316 | \$ 983,489 |

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(Unaudited)

| (Dollars in thousands, except per share data)           | Three Months Ended |          | Six Months Ended |           |
|---|--------------------|----------|------------------|-----------|
|   | June 30,           |          | June 30,         |           |
|   | 2016               | 2015     | 2016             | 2015      |
| <b>INTEREST INCOME</b>                                  |                    |          |                  |           |
| Interest and fees on loans                              | \$ 5,468           | \$ 5,372 | \$ 10,924        | \$ 10,692 |
| Interest and dividend income on investment securities:  |                    |          |                  |           |
| Taxable   | 1,436              | 1,657    | 2,944            | 3,348     |
| Tax-exempt  | 940                | 733      | 1,862            | 1,404     |
| Dividends   | 16                 | 15       | 31               | 30        |
| Dividend income on restricted investment in bank stocks | 64                 | 72       | 124              | 276       |
| Interest on interest-bearing deposits in other banks    | 8                  | 8        | 16               | 16        |
| Total interest income                                   | 7,932              | 7,857    | 15,901           | 15,766    |
| <b>INTEREST EXPENSE</b>                                 |                    |          |                  |           |
| Interest on deposits                                    | 825                | 776      | 1,679            | 1,528     |
| Interest on short-term borrowings                       | 90                 | 66       | 161              | 130       |
| Interest on long-term borrowings                        | 370                | 387      | 755              | 763       |
| Total interest expense                                  | 1,285              | 1,229    | 2,595            | 2,421     |
| Net interest income                                     | 6,647              | 6,628    | 13,306           | 13,345    |
| Provision for loan losses                               | 284                | 213      | 567              | 425       |
| Net interest income after provision for loan losses     | 6,363              | 6,415    | 12,739           | 12,920    |
| <b>NON-INTEREST INCOME</b>                              |                    |          |                  |           |
| Trust department  | 230                | 240      | 430              | 454       |
| Service charges and fees                                | 446                | 423      | 861              | 822       |
| Bank owned life insurance income                        | 165                | 165      | 329              | 329       |
| ATM fees and debit card income                          | 331                | 310      | 643              | 593       |
| Gains on sales of mortgage loans                        | 55                 | 133      | 157              | 314       |
| Net investment securities gains                         | 380                | 603      | 394              | 1,095     |
| Impairment charges on equity securities                 |                    | (14 )    |                  | (14 )     |
| Other   | 59                 | 133      | 152              | 257       |
| Total non-interest income                               | 1,666              | 1,993    | 2,966            | 3,850     |
| <b>NON-INTEREST EXPENSE</b>                             |                    |          |                  |           |
| Salaries and employee benefits                          | 2,587              | 2,847    | 5,373            | 5,691     |
| Occupancy, net  | 379                | 406      | 789              | 874       |
| Furniture and equipment                                 | 128                | 144      | 264              | 291       |
| Computer expense  | 235                | 149      | 461              | 383       |
| Professional services                                   | 149                | 158      | 302              | 312       |
| Pennsylvania shares tax                                 | 188                | 190      | 377              | 366       |
| FDIC insurance  | 163                | 129      | 317              | 253       |

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|   |          |          |         |         |
|---|----------|----------|---------|---------|
| ATM and debit card fees                   | 167      | 172      | 306     | 297     |
| Data processing fees                      | 135      | 180      | 268     | 341     |
| Foreclosed assets held for resale expense | 61       | 42       | 112     | 49      |
| Advertising                               | 96       | 107      | 163     | 180     |
| Other                                     | 726      | 872      | 1,422   | 1,642   |
| Total non-interest expense                | 5,014    | 5,396    | 10,154  | 10,679  |
| Income before income tax expense          | 3,015    | 3,012    | 5,551   | 6,091   |
| Income tax expense                        | 524      | 582      | 884     | 1,212   |
| NET INCOME                                | \$ 2,491 | \$ 2,430 | \$4,667 | \$4,879 |
| PER SHARE DATA                            |          |          |         |         |
| Net income per share:                     |          |          |         |         |
| Basic                                     | \$ 0.44  | \$ 0.44  | \$0.83  | \$0.88  |
| Diluted                                   | 0.44     | 0.44     | 0.83    | 0.88    |
| Dividends per share                       | 0.27     | 0.27     | 0.54    | 0.54    |

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

| (Dollars in thousands)  | Three Months<br>Ended<br>June 30, |           |
|---|-----------------------------------|-----------|
|   | 2016                              | 2015      |
| Net Income  | \$2,491                           | \$2,430   |
| Other comprehensive income (loss):  |                                   |           |
| Unrealized net holding gains (losses) on available-for-sale investment securities arising during the period, net of income taxes of \$1,391 and \$(1,721), respectively | 2,687                             | (3,331)   |
| Less reclassification adjustment for net gains included in net income, net of income taxes of \$(129) and \$(205), respectively (a) (c)                                 | (251 )                            | (398 )    |
| Less reclassification adjustment for impairment charge on equity securities included in net income, net of income taxes of \$0 and \$5, respectively (b) (c)            | —                                 | 9         |
| Total other comprehensive income (loss)   | 2,436                             | (3,720)   |
| Total Comprehensive Income (Loss)   | \$4,927                           | \$(1,290) |

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

(b) Gross amounts are included in impairment charges on equity securities on the Consolidated Statements of Income in non-interest income.

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

| (Dollars in thousands)  | Six Months Ended<br>June 30, |         |
|---|------------------------------|---------|
|   | 2016                         | 2015    |
| Net Income  | \$4,667                      | \$4,879 |
| Other comprehensive income (loss):  |                              |         |
| Unrealized net holding gains (losses) on available-for-sale investment securities arising during the period, net of income taxes of \$3,536 and \$(1,005), respectively | 6,858                        | (1,929) |

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|  |          |         |
|--|----------|---------|
| Less reclassification adjustment for net gains included in net income, net of income taxes of \$(134) and \$(372), respectively (a) (c)                      | (260 )   | (723 )  |
| Less reclassification adjustment for impairment charge on equity securities included in net income, net of income taxes of \$0 and \$5, respectively (b) (c) | —        | 9       |
| Total other comprehensive income (loss)  | 6,598    | (2,643) |
| Total Comprehensive Income   | \$11,265 | \$2,236 |

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

(b) Gross amounts are included in impairment charges on equity securities on the Consolidated Statements of Income in non-interest income.

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

See accompanying notes to consolidated financial statements.



## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(Unaudited)

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

|   | Common Stock |          |          | Retained | Accumulated                                |                   | Total                   |
|---|--------------|----------|----------|----------|--|-------------------|-------------------------|
|   | Shares       | Amount   | Surplus  | Earnings | Other<br>Comprehensive<br>Income<br>(Loss) | Treasury<br>Stock | Stockholders'<br>Equity |
| Balance at January 1, 2016  | 5,853,317    | \$11,707 | \$33,830 | \$66,622 | \$ 2,035                                   | \$(5,756 )        | \$ 108,438              |
| Net Income  |              |          |          | 4,667    |  |                   | 4,667                   |
| Other comprehensive income,<br>net of taxes   |              |          |          |          | 6,598                                      |                   | 6,598                   |
| Issuance of common stock under<br>dividend reinvestment plan  | 25,792       | 51       | 620      |          |  |                   | 671                     |
| Dividends - \$0.54 per share  |              |          |          | (3,038 ) |  |                   | (3,038 )                |
| Balance at June 30, 2016  | 5,879,109    | \$11,758 | \$34,450 | \$68,251 | \$ 8,633                                   | \$(5,756 )        | \$ 117,336              |
| Balance at January 1, 2015  | 5,802,521    | \$11,605 | \$32,674 | \$63,485 | \$ 4,330                                   | \$(5,823 )        | \$ 106,271              |
| Net Income  |              |          |          | 4,879    |  |                   | 4,879                   |
| Other comprehensive loss, net of<br>taxes   |              |          |          |          | (2,643 )                                   |                   | (2,643 )                |
| Issuance of common stock under<br>dividend reinvestment plan and<br>exercise of employee stock<br>options | 24,391       | 49       | 551      |          |  | 58                | 658                     |
| Dividends - \$0.54 per share  |              |          |          | (3,011 ) |  |                   | (3,011 )                |
| Balance at June 30, 2015  | 5,826,912    | \$11,654 | \$33,225 | \$65,353 | \$ 1,687                                   | \$(5,765 )        | \$ 106,154              |

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(Unaudited)

*(Dollars in thousands)*

|  | 2016         | 2015             |
|--|--------------|------------------|
| <b>OPERATING ACTIVITIES</b>  |              |                  |
| Net income   | \$4,667      | \$4,879          |
| Adjustments to reconcile net income to net cash provided by operating activities:      |              |                  |
| Provision for loan losses  | 567          | 425              |
| Depreciation and amortization  | 677          | 784              |
| Net premium amortization on investment securities                                      | 1,900        | 1,324            |
| Deferred income tax expense  |              | 113              |
| Gains on sales of mortgage loans   | (157 )       | (297 )           |
| Gains on sales of mortgage loans held for investment transferred to held for sale      |              | (17 )            |
| Proceeds from sales of mortgage loans originated for resale                            | 4,621        | 11,079           |
| Originations of mortgage loans originated for resale                                   | (6,483 )     | (8,853 )         |
| Gains on sales of investment securities  | (394 )       | (1,095 )         |
| Impairment charges on equity securities  |              | 14               |
| Net losses on sales of foreclosed real estate held for resale, including write-downs   | 37           | 33               |
| Decrease (increase) in accrued interest receivable                                     | 154          | (692 )           |
| Earnings on investment in bank owned life insurance                                    | (329 )       | (329 )           |
| Losses on disposals of premises and equipment  |              | 30               |
| Increase in other assets   | (118 )       | (1,201 )         |
| Increase in accrued interest payable   | 59           | 31               |
| Increase (decrease) in other liabilities   | 238          | (2,135 )         |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                       | <b>5,439</b> | <b>4,093</b>     |
| <b>INVESTING ACTIVITIES</b>  |              |                  |
| Proceeds from sales of investment securities available-for-sale                        | 27,408       | 79,740           |
| Proceeds from maturities and redemptions of investment securities available-for-sale   | 6,808        | 12,727           |
| Purchases of investment securities available-for-sale                                  | (25,571)     | (102,185)        |
| Proceeds from maturities and redemptions of investment securities held-to-maturity     | 6            | 1,023            |
| Net change in restricted investment in bank stocks                                     | (880 )       | (937 )           |
| Net decrease (increase) in loans   | 1,512        | (17,512 )        |
| Proceeds from sales of mortgage loans held for investment transferred to held for sale |              | 491              |
| Purchases of premises and equipment  | (208 )       | (122 )           |
| Proceeds from sales of foreclosed assets held for resale                               | 230          |                  |
| <b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>                             | <b>9,305</b> | <b>(26,775 )</b> |
| <b>FINANCING ACTIVITIES</b>  |              |                  |
| Net (decrease) increase in deposits  | (36,127)     | 4,539            |
| Net increase in short-term borrowings  | 19,099       | 15,339           |
| Proceeds from long-term borrowings   | 10,000       | 5,000            |

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|  |          |          |
|--|----------|----------|
| Repayment of long-term borrowings                      | (5,057 ) | (53 )    |
| Common stock issued                                    | 629      | 589      |
| Proceeds from issuance of treasury stock               |          | 32       |
| Dividends paid   | (3,038 ) | (3,011 ) |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES    | (14,494) | 22,435   |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS       | 250      | (247 )   |
| CASH AND CASH EQUIVALENTS, BEGINNING                   | 9,008    | 7,967    |
| CASH AND CASH EQUIVALENTS, ENDING                      | \$9,258  | \$7,720  |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION       |          |          |
| Interest paid  | \$2,536  | \$2,390  |
| Income taxes paid                                      | 1,730    | 1,330    |
| SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES         |          |          |
| Purchased securities settling after quarter end        |          | 1,920    |
| Loans transferred to foreclosed assets held for resale | 75       | 226      |
| Loans transferred (from) to held for sale portfolio    | (171 )   | 491      |
| Common stock subscription receivable                   | 42       | 37       |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three and six month periods ended June 30, 2016, are not necessarily indicative of the results for the year ending December 31, 2016. For further information, refer to the consolidated financial statements and notes thereto included in First Keystone Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015.

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of June 30, 2016 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued. In July 2016, the Corporation anticipates approximately \$449,000 in tax-free claims income from life insurance proceeds as the result of the death benefit which will be paid on a life insurance policy covering one of our former employees that remained an insured person by our bank-owned life insurance program following her separation of employment.

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

Except as disclosed below, there were no new accounting pronouncements affecting the Corporation during the six months ended June 30, 2016 that were not already adopted by the Corporation.

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue requirements in *Revenue Recognition (Topic 605)*. This ASU requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The ASU is effective for annual reporting periods beginning after December 31, 2016, including interim periods within the reporting period. Early application is not permitted. In August 2015, the FASB issued an update ASU 2015-14 which approved a one-year delay of the effective date of this standard. The deferral would require public entities to apply the standard for annual reporting periods beginning after December 15, 2017. Public companies would be permitted to elect to early adopt for annual reporting periods beginning after December 15, 2016. In March 2016, the FASB issued an update ASU 2016-08 which updates the new revenue standard by clarifying the principal versus agent implementation guidance, but does not change the core principle of the new standard. In April 2016, the FASB issued an update ASU 2016-10. The ASU updates the standard by identifying performance obligations and licenses of intellectual property, which clarifies the guidance surrounding licensing arrangements and the identification of performance obligations. In May 2016, the FASB issued an update ASU 2016-12 which articulates narrow-scope improvements and practical expedients. The Corporation is currently evaluating the impact of these ASUs on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity’s accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The adoption of this update is not expected to have a material impact on the Corporation’s consolidated financial position or results of operations.

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

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

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

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

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

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

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as “Available-For-Sale” or “Held-to-Maturity” were as follows at June 30, 2016 and December 31, 2015:

| (Dollars in thousands)                                    | Available-for-Sale Securities |                        |                         |            |
|---|-------------------------------|------------------------|-------------------------|------------|
|   | Amortized Cost                | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| June 30, 2016:  |                               |                        |                         |            |
| U.S. Treasury securities                                  | \$1,015                       | \$ 5                   | \$                      | \$1,020    |
| Obligations of U.S. Government Corporations and Agencies: |                               |                        |                         |            |
| Mortgage-backed   | 112,802                       | 1,596                  | (194 )                  | 114,204    |
| Other   | 11,541                        | 74                     | (24 )                   | 11,591     |
| Obligations of state and political subdivisions           | 201,749                       | 10,828                 |                         | 212,577    |
| Corporate debt securities                                 | 43,623                        | 388                    | (342 )                  | 43,669     |
| Marketable equity securities                              | 1,194                         | 834                    |                         | 2,028      |
| Total   | \$371,924                     | \$ 13,725              | \$ (560 )               | \$385,089  |

| (Dollars in thousands)                                    | Held-to-Maturity Securities |                        |                         |            |
|---|-----------------------------|------------------------|-------------------------|------------|
|   | Amortized Cost              | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| June 30, 2016:  |                             |                        |                         |            |
| Obligations of U.S. Government Corporations and Agencies: |                             |                        |                         |            |
| Mortgage-backed   | \$ 20                       | \$ 1                   | \$                      | \$ 21      |
| Total   | \$ 20                       | \$ 1                   | \$                      | \$ 21      |

| (Dollars in thousands)                                    | Available-for-Sale Securities |                        |                         |            |
|---|-------------------------------|------------------------|-------------------------|------------|
|   | Amortized Cost                | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2015:  |                               |                        |                         |            |
| U.S. Treasury securities                                  | \$1,022                       | \$                     | \$ (1 )                 | \$1,021    |
| Obligations of U.S. Government Corporations and Agencies: |                               |                        |                         |            |
| Mortgage-backed   | 113,847                       | 37                     | (1,410 )                | 112,474    |
| Other   | 21,554                        | 117                    | (79 )                   | 21,592     |
| Obligations of state and political subdivisions           | 195,297                       | 5,425                  | (408 )                  | 200,314    |
| Corporate debt securities                                 | 49,162                        | 10                     | (1,339 )                | 47,833     |
| Marketable equity securities                              | 1,194                         | 813                    |                         | 2,007      |
| Total   | \$382,076                     | \$ 6,402               | \$ (3,237 )             | \$385,241  |

| (Dollars in thousands)                                    | Held-to-Maturity Securities |                        |                         |            |
|---|-----------------------------|------------------------|-------------------------|------------|
|   | Amortized Cost              | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2015:  |                             |                        |                         |            |
| Obligations of U.S. Government Corporations and Agencies: |                             |                        |                         |            |



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|                 |       |      |    |       |
|-----------------|-------|------|----|-------|
| Mortgage-backed | \$ 26 | \$ 1 | \$ | \$ 27 |
| Total           | \$ 26 | \$ 1 | \$ | \$ 27 |

Securities Available-for-Sale with an aggregate fair value of \$255,220,000 at June 30, 2016 and \$326,872,000 at December 31, 2015, and securities Held-to-Maturity with an aggregate book value of \$20,000 at June 30, 2016 and \$26,000 at December 31, 2015, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of \$191,148,000 at June 30, 2016 and \$219,576,000 at December 31, 2015.

The amortized cost, estimated fair value and weighted average yield of debt and equity securities, by contractual maturity, are shown below at June 30, 2016. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

|                        | June 30, 2016      |                          |                           |   |            |                         | Held-To-Maturity         |  |
|------------------------|--------------------|--------------------------|---------------------------|---|------------|-------------------------|--------------------------|--|
|                        | Available-For-Sale |                          | Obligations               |   |            |                         | U.S.                     |  |
|                        | U.S.               |                          | of State                  |   | Corporate  | Marketable              | Government               |  |
|                        | Corporations &     |                          | & Political               |   | Debt       | Equity                  | Corporations &           |  |
|                        | U.S.               | Agencies                 | Subdivisions <sup>2</sup> |   | Securities | Securities <sup>3</sup> | Agencies                 |  |
|                        | Treasury           | Obligations <sup>1</sup> |                           |   |            |                         | Obligations <sup>1</sup> |  |
|                        | Securities         |                          |                           |   |            |                         |                          |  |
| Within 1 Year:         |                    |                          |                           |   |            |                         |                          |  |
| Amortized cost         | \$                 | \$                       | \$ 902                    |   | \$         | \$                      | \$                       |  |
| Fair value             |                    |                          | 908                       |   |            |                         |                          |  |
| Weighted average yield |                    |                          | 6.29                      | % |            |                         |                          |  |
| 1 - 5 Years:           |                    |                          |                           |   |            |                         |                          |  |
| Amortized cost         | 1,015              | 30,977                   | 42,696                    |   | 12,639     |                         | 20                       |  |
| Fair value             | 1,020              | 31,593                   | 44,250                    |   | 12,722     |                         | 21                       |  |
| Weighted average yield | 0.96 %             | 2.06 %                   | 2.80 %                    |   | 2.38 %     |                         | 2.55 %                   |  |
| 5 - 10 Years:          |                    |                          |                           |   |            |                         |                          |  |
| Amortized cost         |                    | 16,821                   | 72,677                    |   | 30,984     |                         |                          |  |
| Fair value             |                    | 17,166                   | 76,116                    |   | 30,947     |                         |                          |  |
| Weighted average yield |                    | 2.06 %                   | 3.29 %                    |   | 2.76 %     |                         |                          |  |
| After 10 Years:        |                    |                          |                           |   |            |                         |                          |  |
| Amortized cost         |                    | 76,545                   | 85,474                    |   | 1,194      |                         |                          |  |
| Fair value             |                    | 77,036                   | 91,303                    |   | 2,028      |                         |                          |  |
| Weighted average yield |                    | 1.67 %                   | 4.58 %                    |   | 5.16 %     |                         |                          |  |
| Total:                 |                    |                          |                           |   |            |                         |                          |  |
| Amortized cost         | \$ 1,015           | \$ 124,343               | \$ 201,749                |   | \$ 43,623  | \$ 1,194                | \$ 20                    |  |
| Fair value             | 1,020              | 125,795                  | 212,577                   |   | 43,669     | 2,028                   | 21                       |  |
| Weighted average yield | 0.96 %             | 1.82 %                   | 3.75 %                    |   | 2.65 %     | 5.16 %                  | 2.55 %                   |  |

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

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

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

There were no aggregate investments with a single issuer (excluding the U.S. Government and U.S. Government Agencies and Corporations) which exceeded ten percent of consolidated stockholders' equity at June 30, 2016. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities.

Proceeds from sales of investments in Available-for-Sale debt and equity securities for the three months ended June 30, 2016 and 2015 were \$20,374,000 and \$31,966,000, respectively. Gross gains realized on these sales were \$380,000 and \$603,000, respectively. There were no losses realized on these sales for the three months ended June 30, 2016 and 2015. Impairment losses realized on Available-for-Sale equity securities for the three months ended June 30, 2016 and 2015 were \$0 and \$14,000, respectively.

Proceeds from sales of investments in Available-for-Sale debt and equity securities for the six months ended June 30, 2016 and 2015 were \$27,408,000 and \$79,740,000, respectively. Gross gains realized on these sales were \$435,000 and \$1,151,000, respectively. Gross losses on these sales were \$41,000 and \$56,000, respectively. Impairment losses realized on Available-for-Sale equity securities for the six months ended June 30, 2016 and 2015 were \$0 and \$14,000, respectively.

There were no proceeds from sales of investments in Held-to-Maturity debt equity securities during the three or six month periods ended June 30, 2016 or 2015. Therefore, there were no gains or losses realized during these periods.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320, *Investments - Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 model, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When other-than-temporary impairment occurs on debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected, and the realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment related to the other factors shall be recognized in other comprehensive income (loss), net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment.

The fair market value of the equity securities tends to fluctuate with the overall equity markets as well as the trends specific to each institution. The equity securities portfolio is reviewed in a similar manner as that of the debt securities with greater emphasis placed on the length of time the market value has been less than the carrying value and the financial sector outlook. The Corporation also reviews dividend payment activities, levels of non-performing assets and loan loss reserves. The starting point for the equity analysis is the length and severity of market value decline. The realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment is recognized in other comprehensive income (loss), net of applicable taxes. The previous cost basis less the other-than-temporary impairment recognized in earnings becomes the new cost basis of the investment.

The Corporation and its investment advisors monitor the entire portfolio monthly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. As of June 30, 2015, we recognized other than temporary impairment on one equity security that was trading below cost basis. We have written down the value of the shares based upon market indications. In management’s opinion, the equity securities reflect a more accurate valuation of the shares after the impairment charge. Based on the factors described above,

management did not consider any securities to be other-than-temporarily impaired at June 30, 2016 or December 31, 2015.

In accordance with disclosures required by FASB ASC 320-10-50, *Investments - Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation's investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of June 30, 2016 and December 31, 2015:

June 30, 2016

| (Dollars in thousands)                                    | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| Available-for-Sale:                                       |                     |                 |                   |                 |            |                 |
| U.S. Treasury securities                                  | \$                  | \$              | \$                | \$              | \$         | \$              |
| Obligations of U.S. Government Corporations and Agencies: |                     |                 |                   |                 |            |                 |
| Mortgage-backed   | 11,375              | (78 )           | 7,751             | (116 )          | 19,126     | (194 )          |
| Other   | 3,676               | (24 )           |                   |                 | 3,676      | (24 )           |
| Obligations of state and political subdivisions           |                     |                 |                   |                 |            |                 |
| Corporate debt securities                                 | 4,467               | (30 )           | 13,464            | (312 )          | 17,931     | (342 )          |
| Marketable equity securities                              |                     |                 |                   |                 |            |                 |
|   | \$ 19,518           | \$ (132 )       | \$ 21,215         | \$ (428 )       | \$ 40,733  | \$ (560 )       |

December 31, 2015

| (Dollars in thousands)                                    | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| Available-for-Sale:                                       |                     |                 |                   |                 |            |                 |
| U.S. Treasury securities                                  | \$ 1,021            | \$ (1 )         | \$                | \$              | \$ 1,021   | \$ (1 )         |
| Obligations of U.S. Government Corporations and Agencies: |                     |                 |                   |                 |            |                 |
| Mortgage-backed   | 86,618              | (1,177 )        | 11,234            | (233 )          | 97,852     | (1,410 )        |
| Other   | 12,962              | (79 )           |                   |                 | 12,962     | (79 )           |
| Obligations of state and political subdivisions           | 26,163              | (258 )          | 8,105             | (150 )          | 34,268     | (408 )          |
| Corporate debt securities                                 | 27,527              | (531 )          | 19,433            | (808 )          | 46,960     | (1,339 )        |
| Marketable equity securities                              |                     |                 |                   |                 |            |                 |
|   | \$ 154,291          | \$ (2,046 )     | \$ 38,772         | \$ (1,191 )     | \$ 193,063 | \$ (3,237 )     |

The Corporation invests in various forms of agency debt including mortgage-backed securities and callable debt. The mortgage-backed securities are issued by FHLMC (“Federal Home Loan Mortgage Corporation”), FNMA (“Federal National Mortgage Association”) or GNMA (“Government National Mortgage Association”). The municipal securities consist of general obligations and revenue bonds. The marketable equity securities consist of stocks in other bank holding companies. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation’s carrying value at any measurement date. Management does not believe any of their 8 securities with a one year or less unrealized loss position or any of their 10 securities with a greater than one year unrealized loss position as of June 30, 2016, represent an other-than-temporary impairment, as these unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

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

##### **Loans**

Net loans are stated at their outstanding unpaid principal balances, net of deferred fees and costs, unearned income and the allowance for loan losses. Interest on loans is recognized as income over the term of each loan, generally, by the accrual method. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the straight line method or the interest method over the contractual life of the related loans as an interest yield adjustment.

Residential mortgage loans held for resale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse.

The loans receivable portfolio is segmented into commercial, residential and consumer loans. Commercial loans consist of the following classes: Commercial and Industrial and Commercial Real Estate.

##### *Commercial and Industrial Lending*

The Corporation originates commercial and industrial loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes, which include short-term loans and lines of credit to finance machinery and equipment, inventory and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Most business lines of credit are written on demand and are reviewed annually.

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum thresholds have been established by the Corporation and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, business financial statements, collateral appraisals, etc. Commercial and industrial loans are typically secured by personal guarantees of the borrower.



In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis of the borrower's ability to repay.

Commercial and industrial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions. Commercial and industrial loans are typically made on the basis of the borrower's ability to make repayment from cash flows from the borrower's primary business activities. As a result, the availability of funds for the repayment of commercial and industrial loans is dependent on the success of the business itself, which in turn, is likely to be dependent upon the general economic environment.

#### *Commercial Real Estate Lending*

The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation's commercial real estate portfolio is secured primarily by commercial retail space, commercial office buildings, residential housing and hotels. Generally, commercial real estate loans have terms that do not exceed twenty years, have loan-to-value ratios of up to eighty percent of the value of the collateral property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. The value of the property is determined by either independent appraisers or internal evaluations by Bank officers.

Commercial real estate loans generally present a higher level of risk than residential real estate secured loans. Repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project and/or the effect of the general economic conditions on income producing properties.

*Residential Real Estate Lending (Including Home Equity)*

The Corporation's residential real estate portfolio is comprised of one-to-four family residential mortgage loan originations, home equity term loans and home equity lines of credit. These loans are generated by the Corporation's marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within or with customers from the Corporation's market area.

The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The Corporation offers fixed-rate mortgage loans with terms up to a maximum of thirty years for both permanent structures and those under construction. Generally, the majority of the Corporation's residential mortgage loans originate with a loan-to-value of eighty percent or less, or those with primary mortgage insurance at ninety-five percent or less. Home equity term loans are secured by the borrower's primary residence and typically have a maximum loan-to-value of eighty percent and a maximum term of fifteen years. In general, home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of eighty percent and a maximum term of twenty years.

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

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

*Consumer Lending*

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

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

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

### **Delinquent Loans**

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

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

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

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

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

### **Allowance for Loan Losses**

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

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

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

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

The general component covers all other loans not identified as impaired and is based on historical losses and qualitative factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over a time period that management has determined represents the current credit cycle. Qualitative factors impacting each portfolio segment may include: delinquency trends, loan volume trends, Bank policy changes, management processes and oversight, economic trends (including change in consumer and business disposable incomes, unemployment and under-employment levels, and other conditions), concentrations by industry or product, internal and external loan review processes, collateral value and market conditions, and external factors including regulatory issues and competition.

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A reserve for unfunded lending commitments is provided for possible credit losses on off-balance sheet credit exposures. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and, if necessary, is recorded in other liabilities on the Consolidated Balance Sheets. As of June 30, 2016 and December 31, 2015, the amount of the reserve for unfunded lending commitments was \$192,000 and \$184,000, respectively.

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

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

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

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

Loans modified in a troubled debt restructuring are considered impaired and may or may not be placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally

requires that the borrower demonstrates a period of performance according to the restructured terms of six months.

The Bank utilizes a risk grading matrix as a tool for managing credit risk in the loan portfolio and assigns an asset quality rating (risk grade) to all Commercial and Industrial, Commercial Real Estate, Residential Real Estate and Consumer borrowings. An asset quality rating is assigned using the guidance provided in the Bank's loan policy. Primary responsibility for assigning the asset quality rating rests with the lender. The asset quality rating is validated periodically by both an internal and external loan review process.

The commercial loan grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis is placed on financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The loan grading system for Residential Real Estate and Consumer loans focuses on the borrower's credit score and credit history, debt-to-income ratio and income sources, collateral position and loan-to-value ratio, as well as other variables such as current economic conditions, and individual strengths and weaknesses.

Risk grade characteristics are as follows:

*Risk Grade 1 – MINIMAL RISK through Risk Grade 6 – MANAGEMENT ATTENTION (Pass Grade Categories)*

Risk is evaluated via examination of several attributes including but not limited to financial trends, strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history.

At the low-risk end of the rating scale, a risk grade of 1 – Minimal Risk is the grade reserved for loans with exceptional credit fundamentals and virtually no risk of default or loss. Loan grades then progress through escalating ratings of 2 through 6 based upon risk. Risk Grade 2 – Modest Risk are loans with sufficient cash flows; Risk Grade 3 – Average Risk are loans with key balance sheet ratios slightly above the borrower’s peers; Risk Grade 4 – Acceptable Risk are loans with key balance sheet ratios usually near the borrower’s peers, but one or more ratios may be higher; and Risk Grade 5 – Marginally Acceptable are loans with strained cash flow, increasing leverage and/or weakening markets. Risk Grade 6 – Management Attention are loans with weaknesses resulting from declining performance trends and the borrower’s cash flows may be temporarily strained. Loans in this category are performing according to terms, but present some type of potential concern.

*Risk Grade 7 – SPECIAL MENTION (Non-Pass Category)*

Generally, these loans or assets are currently protected, but are “potentially weak”. They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are currently protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank’s credit position at some future date. No loss of principal or interest is envisioned; however, they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management’s close attention.

*Risk Grade 8 – SUBSTANDARD (Non-Pass Category)*

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have “well-defined” weaknesses that jeopardize the full liquidation of the debt.

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



Risk Grade 9 – DOUBTFUL (Non-Pass Category)

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

The following table presents the classes of the loan portfolio summarized by risk rating as of June 30, 2016 and December 31, 2015:

| (Dollars in thousands)   | Commercial and Industrial |                   | Commercial Real Estate |                   |
|--|---------------------------|-------------------|------------------------|-------------------|
|  | June 30, 2016             | December 31, 2015 | June 30, 2016          | December 31, 2015 |
| Grade:   |                           |                   |                        |                   |
| 1-6 Pass   | \$74,932                  | \$ 80,730         | \$ 243,888             | \$ 242,546        |
| 7 Special Mention  | 4,331                     | 4,194             | 9,216                  | 3,890             |
| 8 Substandard  |                           |                   | 10,031                 | 12,238            |
| 9 Doubtful   |                           |                   |                        |                   |
| Add (deduct): Unearned discount and Net deferred loan fees and costs | 136                       | 150               | 389                    | 344               |
| Total loans  | \$79,399                  | \$ 85,074         | \$ 263,524             | \$ 259,018        |

|  | Residential Real Estate Including Home Equity |                   | Consumer Loans |                   |
|--|---|-------------------|----------------|-------------------|
|  | June 30, 2016                                 | December 31, 2015 | June 30, 2016  | December 31, 2015 |
| Grade:   |   |                   |                |                   |
| 1-6 Pass   | \$ 165,568                                    | \$ 163,690        | \$ 6,198       | \$ 5,764          |
| 7 Special Mention  | 1,063   | 1,667             | 17             | 26                |
| 8 Substandard  | 1,119   | 1,245             | 5              | 4                 |
| 9 Doubtful   |   |                   |                |                   |
| Add (deduct): Unearned discount and Net deferred loan fees and costs | (10 )   | (15 )             | 100            | 96                |
| Total loans  | \$ 167,755                                    | \$ 166,628        | \$ 6,320       | \$ 5,890          |

|  | Total Loans   |                   |
|--|---------------|-------------------|
|  | June 30, 2016 | December 31, 2015 |
| Grade:   |               |                   |
| 1-6 Pass   | \$490,586     | \$ 492,730        |
| 7 Special Mention  | 14,627        | 9,777             |
| 8 Substandard  | 11,155        | 13,487            |
| 9 Doubtful   |               |                   |
| Add (deduct): Unearned discount and Net deferred loan fees and costs | (10 )         | (15 )             |
| Total loans  | \$516,998     | \$ 516,610        |

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of \$40,186,000 and \$2,877,000 at June 30, 2016 and \$43,817,000 and \$2,992,000 at December 31, 2015. Loans held for sale amounted to \$3,755,000 at June 30, 2016 and \$1,929,000 at December 31, 2015.

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

| (Dollars in thousands)                                    | Commercial<br>and<br>Industrial | Commercial<br>Real<br>Estate | Residential<br>Real<br>Estate | Consumer | Unallocated | Total   |
|---|---------------------------------|------------------------------|-------------------------------|----------|-------------|---------|
| As of and for the three month period ended June 30, 2016: |                                 |                              |                               |          |             |         |
| Allowance for Loan Losses:                                |                                 |                              |                               |          |             |         |
| Beginning balance   | \$ 731                          | \$ 3,983                     | \$ 1,749                      | \$ 101   | \$ 448      | \$7,012 |
| Charge-offs   | (2 )                            | (57 )                        | (25 )                         |          |             | (84 )   |
| Recoveries  | 4                               |                              |                               | 3        |             | 7       |
| Provision   | (31 )                           | 88                           | (27 )                         | 2        | 252         | 284     |
| Ending Balance  | \$ 702                          | \$ 4,014                     | \$ 1,697                      | \$ 106   | \$ 700      | \$7,219 |

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

| (Dollars in thousands)                                    | Commercial<br>and<br>Industrial | Commercial<br>Real<br>Estate | Residential<br>Real<br>Estate | Consumer | Unallocated | Total |
|---|---------------------------------|------------------------------|-------------------------------|----------|-------------|-------|
| As of and for the three month period ended June 30, 2015: |                                 |                              |                               |          |             |       |
| Allowance for Loan Losses:                                |                                 |                              |                               |          |             |       |

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|                   |        |          |          |       |        |         |
|-------------------|--------|----------|----------|-------|--------|---------|
| Beginning balance | \$ 687 | \$ 3,019 | \$ 1,852 | \$ 90 | \$ 837 | \$6,485 |
| Charge-offs       |        | (94 )    | (49 )    | (1 )  |        | (144 )  |
| Recoveries        | 3      | 42       |          | 1     |        | 46      |
| Provision         | 16     | 172      | 64       | (1 )  | (38 )  | 213     |
| Ending Balance    | \$ 706 | \$ 3,139 | \$ 1,867 | \$ 89 | \$ 799 | \$6,600 |

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| (Dollars in thousands)                                     | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Residential<br>Real<br>Estate | Consumer | Unallocated | Total     |
|--|---------------------------------|---------------------------|-------------------------------|----------|-------------|-----------|
| As of and for the six month period ended<br>June 30, 2015: |                                 |                           |                               |          |             |           |
| Allowance for Loan Losses:                                 |                                 |                           |                               |          |             |           |
| Beginning balance  | \$ 542                          | \$ 3,176                  | \$ 1,928                      | \$ 107   | \$ 637      | \$6,390   |
| Charge-offs  | (2 )                            | (137 )                    | (108 )                        | (15 )    |             | (262 )    |
| Recoveries   | 3                               | 42                        |                               | 2        |             | 47        |
| Provision  | 163                             | 58                        | 47                            | (5 )     | 162         | 425       |
| Ending Balance   | \$ 706                          | \$ 3,139                  | \$ 1,867                      | \$ 89    | \$ 799      | \$6,600   |
| Ending balance: individually evaluated for<br>impairment   | \$                              | \$ 24                     | \$ 66                         | \$       | \$          | \$90      |
| Ending balance: collectively evaluated for<br>impairment   | \$ 706                          | \$ 3,115                  | \$ 1,801                      | \$ 89    | \$ 799      | \$6,510   |
| Loans Receivable:  |                                 |                           |                               |          |             |           |
| Ending Balance   | \$ 78,077                       | \$ 256,184                | \$ 162,463                    | \$ 5,448 | \$          | \$502,172 |
| Ending balance: individually evaluated for<br>impairment   | \$ 414                          | \$ 9,174                  | \$ 1,029                      | \$ 2     | \$          | \$10,619  |
| Ending balance: collectively evaluated for<br>impairment   | \$ 77,663                       | \$ 247,010                | \$ 161,434                    | \$ 5,446 | \$          | \$491,553 |

| (Dollars in thousands)                                      | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Residential<br>Real<br>Estate | Consumer | Unallocated | Total     |
|---|---------------------------------|---------------------------|-------------------------------|----------|-------------|-----------|
| As of and for the twelve months ended<br>December 31, 2015: |                                 |                           |                               |          |             |           |
| Allowance for Loan Losses:                                  |                                 |                           |                               |          |             |           |
| Beginning balance   | \$ 542                          | \$ 3,176                  | \$ 1,928                      | \$ 107   | \$ 637      | \$6,390   |
| Charge-offs   | (2 )                            | (1,759 )                  | (210 )                        | (45 )    |             | (2,016 )  |
| Recoveries  | 22                              | 59                        | 1                             | 6        |             | 88        |
| Provision   | 163                             | 2,507                     | 58                            | 28       | (479 )      | 2,277     |
| Ending Balance  | \$ 725                          | \$ 3,983                  | \$ 1,777                      | \$ 96    | \$ 158      | \$6,739   |
| Ending balance: individually evaluated for<br>impairment    | \$                              | \$ 309                    | \$ 31                         | \$       | \$          | \$340     |
| Ending balance: collectively evaluated for<br>impairment    | \$ 725                          | \$ 3,674                  | \$ 1,746                      | \$ 96    | \$ 158      | \$6,399   |
| Loans Receivable:   |                                 |                           |                               |          |             |           |
| Ending Balance  | \$ 85,074                       | \$ 259,018                | \$ 166,628                    | \$ 5,890 | \$          | \$516,610 |
| Ending balance: individually evaluated for<br>impairment    | \$ 399                          | \$ 12,057                 | \$ 911                        | \$       | \$          | \$13,367  |
| Ending balance: collectively evaluated for<br>impairment    | \$ 84,675                       | \$ 246,961                | \$ 165,717                    | \$ 5,890 | \$          | \$503,243 |

Of the \$1,280,000 in foreclosed assets held for resale at June 30, 2016, \$105,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,125,000 was secured by commercial real estate. Of the \$1,472,000 in foreclosed assets held for resale at December 31, 2015, \$256,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,166,000 was secured by commercial real estate. At June 30, 2016 and December 31, 2015, all foreclosed assets were held as the result of obtaining physical possession. Consumer mortgage loans secured by residential real estate for which the Bank has entered into formal foreclosure proceedings but for which physical possession of the property has yet to be obtained amounted to \$266,000 at June 30, 2016 and \$221,000 at December 31, 2015. These balances were not included in foreclosed assets held for resale at June 30, 2016 or December 31, 2015.

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

The outstanding balance of TDRs as of June 30, 2016 and December 31, 2015 was \$11,091,000 and \$11,096,000, respectively. The small decrease in TDRs at June 30, 2016 as compared to December 31, 2015 is attributable to large principal payments and paydowns made on existing TDRs net against smaller loans modified as TDRs during the six months ended June 30, 2016. There were \$18,000 and \$31,000 in unfunded commitments on TDRs at June 30, 2016 and December 31, 2015, respectively.

During the three months ended June 30, 2016, three loans with a combined post modification balance of \$114,000 were classified as TDRs, as compared to the same period in 2015, when three loans with a combined post modification balance of \$308,000 were classified as TDRs. The loan modifications for the three months ended June 30, 2016 consisted of two term modifications and one payment modification. The loan modifications for the three months ended June 30, 2015 consisted of two term modifications and one payment modification.

During the six months ended June 30, 2016, seven loans with a combined post modification balance of \$542,000 were classified as TDRs, as compared to the same period in 2015, when five loans with a combined post modification balance of \$4,558,000 were classified as TDRs. The loan modifications for the six months ended June 30, 2016 consisted of five term modifications and two payment modifications. The loan modifications for the six months ended June 30, 2015 consisted of three term modifications and two payment modifications.

The following table presents the unpaid balance of TDRs at the dates indicated:

*(Dollars in thousands)*

|                  | June 30,<br>2016 | December<br>31,<br>2015 |
|------------------|------------------|-------------------------|
| Non-accrual TDRs | \$ 300           | \$ 477                  |
| Accruing TDRs    | 10,791           | 10,619                  |
| Total            | \$ 11,091        | \$ 11,096               |

At June 30, 2016, five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$748,000 were not in compliance with the terms of their restructure, compared to June 30, 2015 when five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$6,393,000 were not in compliance with the terms of their restructure. The significant decrease in TDRs not in compliance with the terms of their restructure at June 30, 2016 as compared to June 30, 2015 is largely due to the proper measures being taken to bring two loans totaling \$5,639,000 into compliance with the terms of their restructure. One loan to a student housing holding company in the amount of \$4,226,000 was not in compliance with the terms of its restructure at June 30, 2015, but proper measures were taken to bring the loan into compliance with restructure terms by June 30, 2016. A purchased participation loan in the amount of \$1,413,000 to a distributor of recreational vehicles was not in



compliance with the terms of its restructure at June 30, 2015. A piece of property related to this loan, valued at \$925,000, was moved to foreclosed assets held for resale at December 31, 2015, and proper measures were taken to bring the remainder of the loan into compliance with restructure terms by June 30, 2016.

During the three months ended June 30, 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same period in 2015 when one Commercial Real Estate loan totaling \$4,226,000 that was modified as a TDR within the preceding twelve months had experienced a payment default. During the six months ended June 30, 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same period in 2015 when two Commercial Real Estate loans totaling \$4,446,000 that were modified as TDRs within the preceding twelve months had experienced payment defaults. The significant decrease in defaulted TDRs at June 30, 2016 as compared to June 30, 2015 is largely due to one loan in the amount of \$4,226,000 to a student housing holding company, which was modified as a TDR in the first quarter of 2015 and experienced its subsequent payment default during the second quarter of 2015.

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The following table presents information regarding the loan modifications categorized as TDRs during the three and six months ended June 30, 2016 and June 30, 2015:

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

| (Dollars in thousands)    | Three Months Ended June 30, 2015 |                                 |                                 |                     |
|---------------------------|----------------------------------|---------------------------------|---------------------------------|---------------------|
|                           |                                  | Pre-Modification                | Post-Modification               |                     |
|                           | Number of Contracts              | Outstanding Recorded Investment | Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial |                                  | \$                              | \$                              | \$                  |
| Commercial Real Estate    | 3                                | 354                             | 308                             | 308                 |
| Total                     | 3                                | \$ 354                          | \$ 308                          | \$ 308              |

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

| (Dollars in thousands)    | Six Months Ended June 30, 2015 |                                 |                                 |                     |
|---------------------------|--------------------------------|---------------------------------|---------------------------------|---------------------|
|                           |                                | Pre-Modification                | Post-Modification               |                     |
|                           | Number of Contracts            | Outstanding Recorded Investment | Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial | 1                              | \$ 23                           | \$ 23                           | \$ 22               |
| Commercial Real Estate    | 4                              | 4,580                           | 4,535                           | 4,533               |
| Total                     | 5                              | \$ 4,603                        | \$ 4,558                        | \$ 4,555            |

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the three and six months ended June 30, 2016 and June 30, 2015 with the total number of each type of

modification performed.

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

|                           | Three Months Ended June 30, 2015 |                   |                      | Six Months Ended June 30, 2015 |                   |                   |                      |                 |
|---------------------------|----------------------------------|-------------------|----------------------|--------------------------------|-------------------|-------------------|----------------------|-----------------|
|                           | Rate Modification                | Term Modification | Payment Modification | Number Modified                | Rate Modification | Term Modification | Payment Modification | Number Modified |
| Commercial and Industrial |                                  |                   |                      |                                |                   |                   |                      | 1               |
| Commercial Real Estate    |                                  | 2                 | 1                    | 3                              |                   | 2                 | 2                    | 4               |
| Total                     |                                  | 2                 | 1                    | 3                              |                   | 3                 | 2                    | 5               |

The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended June 30, 2016 and December 31, 2015.

| (Dollars in thousands)              | June 30, 2016       |                          |                   | December 31, 2015   |                          |                   |
|-------------------------------------|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|                                     | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded: |                     |                          |                   |                     |                          |                   |
| Commercial and Industrial           | \$478               | \$478                    | \$                | \$399               | \$399                    | \$                |
| Commercial Real Estate              | 6,781               | 8,020                    |                   | 7,853               | 9,524                    |                   |
| Residential Real Estate             | 434                 | 603                      |                   | 475                 | 657                      |                   |
| With an allowance recorded:         |                     |                          |                   |                     |                          |                   |
| Commercial Real Estate              | 5,212               | 6,567                    | 393               | 4,204               | 4,204                    | 309               |
| Residential Real Estate             | 424                 | 424                      | 19                | 436                 | 436                      | 31                |
| Total                               | \$13,329            | \$16,092                 | \$ 412            | \$13,367            | \$15,220                 | \$ 340            |
| Total consists of:                  |                     |                          |                   |                     |                          |                   |
| Commercial and Industrial           | \$478               | \$478                    | \$                | \$399               | \$399                    | \$                |
| Commercial Real Estate              | \$11,993            | \$14,587                 | \$ 393            | \$12,057            | \$13,728                 | \$ 309            |
| Residential Real Estate             | \$858               | \$1,027                  | \$ 19             | \$911               | \$1,093                  | \$ 31             |

At June 30, 2016 and December 31, 2015, \$11,091,000 and \$11,096,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of \$256,000 and \$309,000, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid principal balance is equal to the gross amount due on the loan.

The average recorded investment and interest income recognized for the Corporation's impaired loans are summarized below for the three and six months ended June 30, 2016 and 2015.

| (Dollars in thousands)              | For the Three Months Ended<br>June 30, 2016 |                            | For the Three Months Ended<br>June 30, 2015 |                            |
|-------------------------------------|---|----------------------------|---|----------------------------|
|                                     | Average Recorded Investment                 | Interest Income Recognized | Average Recorded Investment                 | Interest Income Recognized |
| With no related allowance recorded: |   |                            |   |                            |
| Commercial and Industrial           | \$ 472                                      | \$ 5                       | \$ 416                                      | \$ 5                       |
| Commercial Real Estate              | 6,913                                       | 83                         | 8,943                                       | 141                        |
| Residential Real Estate             | 423   |                            | 441   |                            |
| Consumer                            |   |                            | 3   |                            |

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With an allowance recorded:

|                         |           |        |           |        |
|-------------------------|-----------|--------|-----------|--------|
| Commercial Real Estate  | 5,179     | 37     | 257       |        |
| Residential Real Estate | 424       |        | 547       |        |
| Total                   | \$ 13,411 | \$ 125 | \$ 10,607 | \$ 146 |

Total consists of:

|                           |           |        |          |        |
|---------------------------|-----------|--------|----------|--------|
| Commercial and Industrial | \$ 472    | \$ 5   | \$ 416   | \$ 5   |
| Commercial Real Estate    | \$ 12,092 | \$ 120 | \$ 9,200 | \$ 141 |
| Residential Real Estate   | \$ 847    | \$     | \$ 988   | \$     |
| Consumer                  | \$        | \$     | \$ 3     | \$     |

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Of the \$125,000 and \$146,000 in interest income recognized on impaired loans for the three months ended June 30, 2016 and 2015, respectively, no interest income was recognized with respect to non-accrual loans.

| (Dollars in thousands)              | For the Six Months Ended |            | For the Six Months Ended |            |
|-------------------------------------|--------------------------|------------|--------------------------|------------|
|                                     | June 30, 2016            |            | June 30, 2015            |            |
|                                     | Average                  | Interest   | Average                  | Interest   |
|                                     | Recorded                 | Recognized | Recorded                 | Recognized |
|                                     | Investment               | Investment | Investment               | Investment |
| With no related allowance recorded: |                          |            |                          |            |
| Commercial and Industrial           | \$447                    | \$ 10      | \$410                    | \$ 9       |
| Commercial Real Estate              | 6,904                    | 171        | 7,599                    | 247        |
| Residential Real Estate             | 422                      |            | 414                      |            |
| Consumer                            |                          |            | 3                        |            |
| With an allowance recorded:         |                          |            |                          |            |
| Commercial Real Estate              | 5,176                    | 74         | 259                      |            |
| Residential Real Estate             | 428                      |            | 553                      |            |
| Total                               | \$13,377                 | \$ 255     | \$9,238                  | \$ 256     |
| Total consists of:                  |                          |            |                          |            |
| Commercial and Industrial           | \$447                    | \$ 10      | \$410                    | \$ 9       |
| Commercial Real Estate              | \$12,080                 | \$ 245     | \$7,858                  | \$ 247     |
| Residential Real Estate             | \$850                    | \$         | \$967                    | \$         |
| Consumer                            | \$                       | \$         | \$3                      | \$         |

Of the \$255,000 and \$256,000 in interest income recognized on impaired loans for the six months ended June 30, 2016 and 2015, respectively, no interest income was recognized with respect to non-accrual loans.

Loans receivable on non-accrual status, foreclosed assets held for resale and loans past-due 90 days or more and still accruing, as of June 30, 2016 and December 31, 2015 were as follows:

| (Dollars in thousands)                            | June 30, | December 31, |
|---|----------|--------------|
|   | 2016     | 2015         |
| Commercial Real Estate                            | \$ 1,680 | \$ 1,837     |
| Residential Real Estate                           | 858      | 911          |
| Total non-accrual loans                           | 2,538    | 2,748        |
| Foreclosed assets held for resale                 | 1,280    | 1,472        |
| Loans past-due 90 days or more and still accruing | 431      | 166          |
| Total non-performing assets                       | \$ 4,249 | \$ 4,386     |

The following tables present the classes of the loan portfolio summarized by the past-due status at June 30, 2016 and December 31, 2015:

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(Dollars in thousands)

|                           | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days<br>or Greater<br>Past Due | Total<br>Past Due | Current   | Total<br>Loans | 90 Days<br>Or Greater<br>Past Due<br>and Still<br>Accruing |
|---------------------------|------------------------|------------------------|-----------------------------------|-------------------|-----------|----------------|--|
| June 30, 2016:            |                        |                        |                                   |                   |           |                |  |
| Commercial and Industrial | \$ 638                 | \$ 63                  | \$                                | \$ 701            | \$78,698  | \$79,399       | \$   |
| Commercial Real Estate    | 1,357                  | 627                    | 1,901                             | 3,885             | 259,639   | 263,524        | 398  |
| Residential Real Estate   | 974                    | 26                     | 848                               | 1,848             | 165,907   | 167,755        | 33   |
| Consumer                  | 11                     |                        |                                   | 11                | 6,309     | 6,320          |  |
| Total                     | \$ 2,980               | \$ 716                 | \$ 2,749                          | \$ 6,445          | \$510,553 | \$516,998      | \$ 431   |

(Dollars in thousands)

|                           | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days<br>or Greater<br>Past Due | Total<br>Past Due | Current   | Total<br>Loans | 90 Days<br>Or Greater<br>Past Due<br>and Still<br>Accruing |
|---------------------------|------------------------|------------------------|-----------------------------------|-------------------|-----------|----------------|--|
| December 31, 2015:        |                        |                        |                                   |                   |           |                |  |
| Commercial and Industrial | \$ 34                  | \$                     | \$                                | \$ 34             | \$85,040  | \$85,074       | \$   |
| Commercial Real Estate    | 316                    | 3                      | 1,484                             | 1,803             | 257,215   | 259,018        |  |
| Residential Real Estate   | 1,288                  | 491                    | 1,049                             | 2,828             | 163,800   | 166,628        | 166  |
| Consumer                  | 20                     |                        |                                   | 20                | 5,870     | 5,890          |  |
| Total                     | \$ 1,658               | \$ 494                 | \$ 2,533                          | \$ 4,685          | \$511,925 | \$516,610      | \$ 166   |

At June 30, 2016, commitments to lend additional funds with respect to impaired loans consisted of three irrevocable letters of credit totaling \$2,204,000. One irrevocable letter of credit in the amount of \$2,185,000 was associated with a loan to a developer of a residential sub-division. Two irrevocable letters of credit totaling \$19,000 were associated with a loan to a community recreation facility. At December 31, 2015, the only commitment to lend additional funds with respect to impaired loans was an irrevocable letter of credit in the amount of \$2,185,000 associated with a loan to a developer of a residential sub-division.

## NOTE 5 — BORROWINGS

### Short-Term Borrowings

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

### Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets.



As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability on the Corporation's Consolidated Balance Sheets, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is not offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). The collateral is held by a correspondent bank in the counterparty's custodial account. The counterparty has the right to sell or repledge the investment securities.

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of June 30, 2016 and December 31, 2015.

| (Dollars in thousands)    | Gross<br>Amounts of<br>Recognized<br>Liabilities | Gross<br>Amounts<br>Offset<br>in the<br>Consolidated<br>Balance<br>Sheet | Net Amounts<br>of Liabilities<br>Presented<br>in the<br>Consolidated<br>Balance<br>Sheet | Financial<br>Instruments | Cash<br>Collateral<br>Pledge | Net<br>Amount |
|---------------------------|--|--|--|--------------------------|------------------------------|---------------|
| June 30, 2016             |  |  |  |                          |                              |               |
| Repurchase agreements (a) | \$ 24,029  | \$   | \$ 24,029  | \$ (24,029 )             | \$                           | \$            |
| December 31, 2015         |  |  |  |                          |                              |               |
| Repurchase agreements (a) | \$ 20,779  | \$   | \$ 20,779  | \$ (20,779 )             | \$                           | \$            |

(a) As of June 30, 2016 and December 31, 2015, the fair value of securities pledged in connection with repurchase agreements was \$27,713,000 and \$27,510,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of June 30, 2016:

| (Dollars in thousands)   | Remaining Contractual Maturity of the Agreements |                     |                       |                               |           |
|--|--|---------------------|-----------------------|-------------------------------|-----------|
|  | Overnight<br>and<br>Continuous                   | Up to<br>30<br>days | 30<br>-<br>90<br>Days | Greater<br>than<br>90<br>Days | Total     |
| June 30, 2016:   |  |                     |                       |                               |           |
| Repurchase agreements and repurchase-to-maturity transactions: |  |                     |                       |                               |           |
| U.S. Treasury and/or agency securities                         | \$ 24,029  | \$                  | \$                    | \$                            | \$ 24,029 |
| Total  | \$ 24,029  | \$                  | \$                    | \$                            | \$ 24,029 |

### Long-Term Borrowings

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

**NOTE 6 — COMMITMENTS AND CONTINGENCIES**

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the consolidated financial statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position or results of operations of the Corporation.

**NOTE 7 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK**

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

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

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

The contract or notional amounts at June 30, 2016 and December 31, 2015, were as follows:

*(Dollars in thousands)*

|   | June 30,<br>2016 | December<br>31, 2015 |
|---|------------------|----------------------|
| Financial instruments whose contract amounts represent credit risk: |                  |                      |
| Commitments to extend credit  | \$85,194         | \$ 72,552            |
| Financial standby letters of credit                                 | \$452            | \$ 475               |
| Performance standby letters of credit                               | \$4,660          | \$ 4,692             |

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

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

#### **NOTE 8 — FAIR VALUE MEASUREMENTS**

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This guidance provides additional information on determining when the volume and level of activity for the asset or liability has significantly decreased. The guidance also includes information on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with the fair value measurement and disclosure guidance.

This guidance clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own belief about the assumptions market participants would use in pricing the asset or liability based upon the best information available in the circumstances. Fair value measurement and disclosure guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Inputs: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 Inputs: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth as follows.

### **Financial Assets Measured at Fair Value on a Recurring Basis**

At June 30, 2016 and December 31, 2015, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

June 30, 2016

Level 1    Level 2    Level 3    Total

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|   |    |         |            |
|---|----|---------|------------|
| Available-for-Sale Securities:                            |    |         |            |
| U.S. Treasury securities                                  | \$ | \$1,020 | \$ 1,020   |
| Obligations of U.S. Government Corporations and Agencies: |    |         |            |
| Mortgage-backed   |    | 114,204 | 114,204    |
| Other   |    | 11,591  | 11,591     |
| Obligations of state and political subdivisions           |    | 212,577 | 212,577    |
| Corporate debt securities                                 |    | 43,669  | 43,669     |
| Marketable equity securities                              |    | 2,028   | 2,028      |
| Total   | \$ | \$2,028 | \$ 385,089 |

*(Dollars in thousands)*

December 31, 2015

|   | Level 1 | Level 2 | Level 3 | Total     |
|---|---------|---------|---------|-----------|
| Available-for-Sale Securities:                            |         |         |         |           |
| U.S. Treasury securities                                  | \$      | \$1,021 | \$      | \$1,021   |
| Obligations of U.S. Government Corporations and Agencies: |         |         |         |           |
| Mortgaged-backed  |         | 112,474 |         | 112,474   |
| Other   |         | 21,592  |         | 21,592    |
| Obligations of state and political subdivisions           |         | 200,314 |         | 200,314   |
| Corporate debt securities                                 |         | 47,833  |         | 47,833    |
| Marketable equity securities                              |         | 2,007   |         | 2,007     |
| Total   | \$      | \$2,007 | \$      | \$383,234 |

The estimated fair values of equity securities classified as Level 1 are derived from quoted market prices in active markets; these assets consist mainly of stocks held in other banks. The estimated fair values of all debt securities classified as Level 2 are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Corporation (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy. The Corporation does not have any Level 3 inputs for investments. There were no transfers between Level 1 and Level 2 during 2016 or 2015.

### Financial Assets Measured at Fair Value on a Non-recurring Basis

At June 30, 2016 and December 31, 2015, impaired loans measured at fair value on a non-recurring basis that are collateral dependent and the valuation methods used are as follows:

*(Dollars in thousands)*

|                         | Level<br>1 | Level<br>2 | Level<br>3 | Total   |
|-------------------------|------------|------------|------------|---------|
| Assets at June 30, 2016 |            |            |            |         |
| Impaired loans:         |            |            |            |         |
| Commercial Real Estate  | \$         | \$         | \$5,289    | \$5,289 |
| Residential Real Estate |            |            | 549        | 549     |
| Total impaired loans    | \$         | \$         | \$5,838    | \$5,838 |

*(Dollars in thousands)*

|                             | Level<br>1 | Level<br>2 | Level<br>3 | Total   |
|-----------------------------|------------|------------|------------|---------|
| Assets at December 31, 2015 |            |            |            |         |
| Impaired loans:             |            |            |            |         |
| Commercial Real Estate      | \$         | \$         | \$1,665    | \$1,665 |
| Residential Real Estate     |            |            | 631        | 631     |
| Total impaired loans        | \$         | \$         | \$2,296    | \$2,296 |

The Bank's impaired loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values. For impaired loans less than \$250,000 upon classification and annually at year end, the Bank completes a Certificate of Inspection, which includes an onsite inspection, insured values, tax assessed values, recent sales comparisons and a



review of the previous evaluations. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. The fair value consists of the impaired loan balances less the valuation allowance and/or charge-offs. There were no transfers between valuation levels in 2016 and 2015.

### Nonfinancial Assets Measured at Fair Value on a Non-recurring Basis

At June 30, 2016, foreclosed assets held for resale measured at fair value on a non-recurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

|   | Level<br>1 | Level<br>2 | Level<br>3 | Total |
|---|------------|------------|------------|-------|
| Assets at June 30, 2016                 |            |            |            |       |
| Foreclosed assets held for resale:      |            |            |            |       |
| Commercial Real Estate                  | \$         | \$         | \$200      | \$200 |
| Total foreclosed assets held for resale | \$         | \$         | \$200      | \$200 |

At December 31, 2015, there were no nonfinancial assets measured at fair value on a non-recurring basis.

The Bank's foreclosed asset valuation procedure requires an appraisal, which considers the sales prices of similar properties in the proximate vicinity, to be completed periodically with the exception of those cases which the Bank has obtained a sales agreement. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2016 and 2015.

The following table presents additional quantitative information about assets measured at fair value on a non-recurring basis that are collateral dependent and for which the Bank has utilized Level 3 inputs to determine the fair value:

(Dollars in thousands)

|                                   | Quantitative Information about Level 3 Fair Value Measurements |  |                                    | Weighted Average |        |
|-----------------------------------|--|--|------------------------------------|------------------|--------|
|                                   | Fair Value Estimate  | Valuation Technique                    | Unobservable Input                 |                  |        |
| June 30, 2016                     |  |  |                                    |                  |        |
| Impaired loans                    | \$5,838  | Appraisal of collateral <sup>1,3</sup> | Appraisal adjustments <sup>2</sup> | (10%) – (63%)    | (19 %) |
| Foreclosed assets held for resale | \$200  | Appraisal of collateral <sup>1,3</sup> | Appraisal adjustments <sup>2</sup> | (17%) – (17%)    | (17 %) |
| December 31, 2015                 |  |  |                                    |                  |        |
| Impaired loans                    | \$2,296  | Appraisal of collateral <sup>1,3</sup> | Appraisal adjustments <sup>2</sup> | (10%) – (63%)    | (29 %) |
| Foreclosed assets held for resale | \$   | Appraisal of collateral <sup>1,3</sup> | Appraisal adjustments <sup>2</sup> | (0%) – (0%)      | (0 %)  |

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

<sup>2</sup>Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The typical range of appraisal adjustments are presented as a percent of the appraisal value.

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

## Fair Value of Financial Instruments

(Dollars in thousands)

|  | Carrying Amount | Fair Value Measurements at June 30, 2016 |         |         | Total   |
|--|-----------------|--|---------|---------|---------|
|  |                 | Level 1                                  | Level 2 | Level 3 |         |
| <b>FINANCIAL ASSETS:</b>                 |                 |  |         |         |         |
| Cash and due from banks                  | \$8,586         | \$8,586                                  | \$      | \$      | \$8,586 |
| Interest-bearing deposits in other banks | 672             |  | 672     |         | 672     |
| Time deposits with other banks           | 1,482           |  | 1,482   |         | 1,482   |

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|  |         |       |         |         |
|--|---------|-------|---------|---------|
| Investment securities available-for-sale | 385,089 | 2,028 | 383,061 | 385,089 |
| Investment securities held-to-maturity   | 20      |       | 21      | 21      |
| Restricted investment in bank stocks     | 6,622   |       | 6,622   | 6,622   |
| Net loans                                | 509,779 |       |         | 508,581 |
| Mortgage servicing rights                | 461     |       |         | 461     |
| Accrued interest receivable              | 3,932   |       | 3,932   | 3,932   |

FINANCIAL LIABILITIES:

|                          |         |  |         |         |
|--------------------------|---------|--|---------|---------|
| Deposits                 | 684,471 |  | 686,178 | 686,178 |
| Short-term borrowings    | 99,638  |  | 99,638  | 99,638  |
| Long-term borrowings     | 75,175  |  | 77,279  | 77,279  |
| Accrued interest payable | 441     |  | 441     | 441     |

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

| (Dollars in thousands)                   | Carrying<br>Amount | Fair Value Measurements at December<br>31, 2015 |         |         | Total   |
|--|--------------------|---|---------|---------|---------|
|  |                    | Level<br>1                                      | Level 2 | Level 3 |         |
| <b>FINANCIAL ASSETS:</b>                 |                    |   |         |         |         |
| Cash and due from banks                  | \$7,474            | \$7,474   | \$      | \$      | \$7,474 |
| Interest-bearing deposits in other banks | 1,534              |   | 1,534   |         | 1,534   |
| Time deposits with other banks           | 1,482              |   | 1,482   |         | 1,482   |
| Investment securities available-for-sale | 385,241            | 2,007   | 383,234 |         | 385,241 |
| Investment securities held-to-maturity   | 26                 |   | 27      |         | 27      |
| Restricted investment in bank stocks     | 5,742              |   | 5,742   |         | 5,742   |
| Net loans                                | 509,871            |   |         | 498,671 | 498,671 |
| Mortgage servicing rights                | 493                |   |         | 493     | 493     |
| Accrued interest receivable              | 4,086              |   | 4,086   |         | 4,086   |
| <b>FINANCIAL LIABILITIES:</b>            |                    |   |         |         |         |
| Deposits                                 | 720,598            |   | 720,341 |         | 720,341 |
| Short-term borrowings                    | 80,539             |   | 80,539  |         | 80,539  |
| Long-term borrowings                     | 70,232             |   | 71,302  |         | 71,302  |
| Accrued interest payable                 | 382                |   | 382     |         | 382     |

#### OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at June 30, 2016 and December 31, 2015:

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

The fair values are equal to the current carrying values.

#### **Investment Securities**

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

## **Loans**

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

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

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

## **Mortgage Servicing Rights**

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

## **Deposits**

The fair value of deposits with no stated maturity, such as demand deposits, savings accounts and money market accounts, is equal to the amount payable on demand at June 30, 2016 and December 31, 2015.

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

## **Short-Term and Long-Term Borrowings**

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

## **Off-Balance Sheet Financial Instruments**

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

## **NOTE 9 — EARNINGS PER SHARE**

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Corporation. Potential common shares that may be issued by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method. The following table sets forth the computation of basic and diluted earnings per share.

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| (In thousands, except earnings per share)               | Three Months Ended |          |
|---|--------------------|----------|
|   | June 30,           |          |
|   | 2016               | 2015     |
| Net income  | \$ 2,491           | \$ 2,430 |
| Weighted-average common shares outstanding              | 5,633              | 5,581    |
| Basic earnings per share                                | \$ 0.44            | \$ 0.44  |
| Weighted-average common shares outstanding              | 5,633              | 5,581    |
| Common stock equivalents due to effect of stock options | 2                  | 2        |
| Total weighted-average common shares and equivalents    | 5,635              | 5,583    |
| Diluted earnings per share                              | \$ 0.44            | \$ 0.44  |

| (In thousands, except earnings per share)               | Six Months Ended |          |
|---|------------------|----------|
|   | June 30,         |          |
|   | 2016             | 2015     |
| Net income  | \$ 4,667         | \$ 4,879 |
| Weighted-average common shares outstanding              | 5,627            | 5,574    |
| Basic earnings per share                                | \$ 0.83          | \$ 0.88  |
| Weighted-average common shares outstanding              | 5,627            | 5,574    |
| Common stock equivalents due to effect of stock options | 2                | 2        |
| Total weighted-average common shares and equivalents    | 5,629            | 5,576    |
| Diluted earnings per share                              | \$ 0.83          | \$ 0.88  |

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

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

### CRITICAL ACCOUNTING ESTIMATES

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation applies those accounting policies in a consistent manner. The Significant Accounting Policies are summarized in Note 1 to the consolidated financial statements included in the 2015 Annual Report on Form 10-K. There have been no changes to the Critical Accounting Estimates since the Corporation filed its Annual Report on Form 10-K for the year ended December 31, 2015.

### RESULTS OF OPERATIONS

#### *Quarter ended June 30, 2016 compared to quarter ended June 30, 2015*

First Keystone Corporation realized earnings for the three months ended June 30, 2016 of \$2,491,000, an increase of \$61,000, or 2.5% from the second quarter of 2015. The increase in net income for the three months ended June 30, 2016 was primarily due to a decrease in non-interest expense.

On a per share basis, net income was \$0.44 for the three months ended June 30, 2016 and 2015. Cash dividends amounted to \$0.27 per share for the three months ended June 30, 2016 and 2015.



## NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. For the three months ended June 30, 2016, interest income amounted to \$7,932,000, an increase of \$75,000 or 1.0% from the three months ended June 30, 2015, while interest expense amounted to \$1,285,000 for the three months ended June 30, 2016, an increase of \$56,000, or 4.6% from the three months ended June 30, 2015. As a result, net interest income increased \$19,000 or 0.3% to \$6,647,000 from \$6,628,000 for the same period in 2015.

The Corporation's net interest margin for the three months ended June 30, 2016 was 3.18% compared to 3.25% for the same period in 2015. The decrease in net interest margin was a result of the unprecedented continuing low interest rate environment.

## PROVISION FOR LOAN LOSSES

The provision for loan losses for the three months ended June 30, 2016 and June 30, 2015 was \$284,000 and \$213,000, respectively. The increase in the provision for loan losses resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions, and other relevant factors. Net charge-offs for the three months ended June 30, 2016 and 2015 were \$77,000 and \$98,000, respectively. See Allowance for Loan Losses on page 38 for further discussion.

## NON-INTEREST INCOME

Total non-interest income was \$1,666,000 for the three months ended June 30, 2016, as compared to \$1,993,000 for the same period in 2015, a decrease of \$327,000, or 16.4%. ATM fees and debit card income increased \$21,000 or 6.8% to \$331,000 for the three months ended June 30, 2016. Gains on sales of mortgage loans decreased \$78,000 or 58.6% due to a decrease in loans originated with the intent to sell and volume of loans sold.

Net gains on sales of investment securities decreased \$223,000 to \$380,000 for the three months ended June 30, 2016 as compared to the three months ended June 30, 2015. The Bank has taken gains and losses in the portfolio to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates.

Excluding net investment securities gains and gains on sales of mortgage loans, non-interest income was \$1,231,000 for the three months ended June 30, 2016, a decrease of \$26,000 from the three months ended June 30, 2015.

## NON-INTEREST EXPENSE

Total non-interest expense was \$5,014,000 for the three months ended June 30, 2016, as compared to \$5,396,000 for the three months ended June 30, 2015. Non-interest expense decreased \$382,000 or 7.1%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to \$2,587,000 or 51.6% of total non-interest expense for the three months ended June 30, 2016, as compared to 52.8% for the three months ended June 30, 2015. Significant reductions in salaries and employee benefits expenses were achieved through changes implemented in staffing levels throughout the organization. Net occupancy, furniture and equipment, and computer expense amounted to \$742,000 for the three months ended June 30, 2016, an increase of \$43,000 or 6.2%. The increase was due to higher software maintenance costs. FDIC insurance expense increased \$34,000 or 26.4% as compared to the three months ended June 30, 2015. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. Data processing expenses decreased \$45,000 or 25.0% to \$135,000 for the three months ended June 30, 2016. In 2015, the Bank realized expenses related to the conversion to an outsourced data processing system for item processing and check image solutions, plus normal outsourcing fees for the Bank's core processing system. Foreclosed assets held for resale expense increased \$19,000 due to costs associated with the maintenance and sales of nine properties in 2016 versus four properties in 2015. Other non-interest expense amounted to \$726,000 for the three months ended June 30, 2016, a decrease of \$146,000 or 16.7% as compared to the three months ended June 30, 2015. The decrease was due to fewer charitable donations and the completion of amortization of the core deposit intangible associated with the acquisition of Pocono Community Bank in November 2007. The core deposit intangible was fully

amortized effective June 2015.

## INCOME TAXES

Income tax expense amounted to \$524,000 for the three months ended June 30, 2016, as compared to \$582,000 for the three months ended June 30, 2015, a decrease of \$58,000. The effective total income tax rate was 17.4% for the second quarter of 2016 as compared to 19.3% for the second quarter of 2015. The decrease in the effective tax rate was due to a net increase in tax-exempt interest earned from investments in and loans to state and local units of government, and a decrease in net gains on sales of investment securities.

### *Six months ended June 30, 2016 compared to six months ended June 30, 2015*

First Keystone Corporation realized earnings for the six months ended June 30, 2016 of \$4,667,000, a decrease of \$212,000, or 4.3% from the same period in 2015. The decrease in net income for the six months ended June 30, 2016 was primarily due to a decrease in net investment securities gains.

On a per share basis, for the six months ended June 30, 2016, net income was \$0.83 versus \$0.88 for the six months ended June 30, 2015. Cash dividends amounted to \$0.54 per share for the six months ended June 30, 2016 and 2015.

## NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. For the six months ended June 30, 2016, interest income amounted to \$15,901,000, an increase of \$135,000 or 0.9% from the first six months of 2015, while interest expense amounted to \$2,595,000 for the six months ended June 30, 2016, an increase of \$174,000, or 7.2% from the six months ended June 30, 2015. As a result, net interest income decreased \$39,000 or 0.3% to \$13,306,000 from \$13,345,000 for the same period in 2015.

The Corporation's net interest margin for the six months ended June 30, 2016 was 3.18% compared to 3.29% for the same period in 2015. The decrease in net interest margin was a result of the unprecedented continuing low interest rate environment.

## PROVISION FOR LOAN LOSSES

The provision for loan losses for the six months ended June 30, 2016 and June 30, 2015 was \$567,000 and \$425,000, respectively. The increase in the provision for loan losses resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions, and other relevant factors. Net charge-offs for the six months ended June 30, 2016 and 2015 were \$87,000 and \$215,000, respectively. See Allowance for Loan Losses on page 38 for further discussion.

## NON-INTEREST INCOME

Total non-interest income was \$2,966,000 for the six months ended June 30, 2016, as compared to \$3,850,000 for the same period in 2015, a decrease of \$884,000, or 23.0%. ATM fees and debit card income increased by \$50,000 or 8.4% to \$643,000 for the six months ended June 30, 2016. Gains on sales of mortgage loans decreased \$157,000 or 50.0% due to a decrease in loans originated with the intent to sell and the volume of loans sold.

Net gains on sales of investment securities decreased \$701,000 to \$394,000 for the six months ended June 30, 2016 as compared to the six months ended June 30, 2015. The Bank has taken gains and losses in the portfolio to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates.

Excluding net investment securities gains and gains on sales of mortgage loans, non-interest income was \$2,415,000 for the six months ended June 30, 2016, a decrease of \$26,000 from the six months ended June 30, 2015.

#### NON-INTEREST EXPENSE

Total non-interest expense was \$10,154,000 for the six months ended June 30, 2016, as compared to \$10,679,000 for the six months ended June 30, 2015. Non-interest expense decreased \$525,000 or 4.9%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to \$5,373,000 or 52.9% of total non-interest expense for the six months ended June 30, 2016, as compared to 53.3% for the six months ended June 30, 2015. Significant reductions in salaries and employee benefits expenses were achieved through changes implemented in staffing levels throughout the organization. Net occupancy, furniture and equipment, and computer expense amounted to \$1,514,000 for the six months ended June 30, 2016, a decrease of \$34,000 or 2.2%. The decrease was due to lower maintenance and utilities costs. FDIC insurance expense increased \$64,000 or 25.3% as compared to the six months ended June 30, 2015. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. Data processing expenses decreased \$73,000 or 21.4% to \$268,000 for the six months ended June 30, 2016. In 2015, the Bank, realized expenses related to the conversion to an outsourced data processing system for item processing and check image solutions, plus normal outsourcing fees for the Bank's core processing system. Foreclosed assets held for resale expense increased \$63,000 due to costs associated with the maintenance and sales of nine properties in 2016 versus four properties in 2015. Other non-interest expense amounted to \$1,422,000 for the six months ended June 30, 2016, a decrease of \$220,000 or 13.4% as compared to the six months ended June 30, 2015. The decrease was due to fewer charitable donations, lower data communications expenses and the completion of amortization of the core deposit intangible associated with the acquisition of Pocono Community Bank in November 2007. The core deposit intangible was fully amortized effective June 2015.

## INCOME TAXES

Income tax expense amounted to \$884,000 for the six months ended June 30, 2016, as compared to \$1,212,000 for the six months ended June 30, 2015, a decrease of \$328,000. The effective total income tax rate was 15.9% for the six months ended June 30, 2016 as compared to 19.9% for the six months ended June 30, 2015. The decrease in the effective tax rate was due to a net increase in tax-exempt interest earned from investments in and loans to state and local units of government, and a decrease in net gains on sales of investment securities.

## FINANCIAL CONDITION

### SUMMARY

Total assets decreased to \$983,316,000 as of June 30, 2016, a decrease of \$173,000 from year-end 2015. Total assets as of December 31, 2015 amounted to \$983,489,000.

Total loans increased \$388,000 or 0.1%. Loan demand remained steady in the six months ended June 30, 2016 as the Bank has seen an increase in loan originations, primarily in the commercial real estate portfolio.

Total deposits decreased \$36,127,000 or 5.0% to \$684,471,000 as of June 30, 2016.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Total borrowings increased in the first six months of 2016 by \$24,042,000 to \$174,813,000 from \$150,771,000 as of December 31, 2015. Borrowings increased due to decreased deposit balances.

Total stockholders' equity increased to \$117,336,000 at June 30, 2016, an increase of \$8,898,000 or 8.2% from December 31, 2015.

## SEGMENT REPORTING

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

## EARNING ASSETS

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 92.5% at June 30, 2016, compared to 92.2% at June 30, 2015. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

Our primary earning asset, total loans, increased to \$516,998,000 as of June 30, 2016, up \$388,000, or 0.1% since year-end 2015. The loan portfolio continues to be well diversified. Non-performing assets decreased since year-end 2015, and overall asset quality has remained consistent. Total non-performing assets were \$4,249,000 as of June 30, 2016, a decrease of \$137,000, or 3.1% from \$4,386,000 reported in non-performing assets as of December 31, 2015. Total allowance for loan losses to total non-performing assets was 169.9% as of June 30, 2016 and 153.6% at December 31, 2015.

In addition to loans, another primary earning asset is our overall investment portfolio, which decreased in size from December 31, 2015, to June 30, 2016. Available-for-sale securities amounted to \$385,089,000 as of June 30, 2016, a decrease of \$152,000 from year-end 2015.

Interest-bearing deposits in other banks decreased as of June 30, 2016, to \$672,000 from \$1,534,000 at year-end 2015. Time deposits with other banks were \$1,482,000 at June 30, 2016 and December 31, 2015.

## LOANS

Total loans increased to \$516,998,000 as of June 30, 2016 as compared to \$516,610,000 as of December 31, 2015. The table on page 18 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans increased by \$388,000 or 0.1%.

Steady demand for borrowing by both individuals and businesses accounted for the 0.1% increase in the loan portfolio from December 31, 2015 to June 30, 2016. The Commercial and Industrial portfolio decreased \$5,675,000 to \$79,399,000 as of June 30, 2016, as compared to \$85,074,000 at December 31, 2015. The decrease in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling \$6,851,000 offset by loan payoffs of \$7,515,000, as well as regular principal payments. The significant decrease in the Commercial and Industrial portfolio is primarily due to the payoff of two large tax-free Commercial and Industrial loans during the six months ended June 30, 2016, totaling approximately \$5,742,000 combined with normal portfolio fluctuations. The Commercial Real Estate portfolio (which includes tax-free Commercial Real Estate loans) increased \$4,506,000 to \$263,524,000 at June 30, 2016, as compared to \$259,018,000 at December 31, 2015. The increase was mainly the result of \$13,122,000 in new loan originations, offset by \$2,898,000 in loan payoffs in addition to regular principal payments and other typical amortizations in the Commercial Real Estate portfolio. The significant increase in the Commercial Real Estate portfolio is primarily due to the issuance of two Commercial Real Estate term loans during the six months ended June 30, 2016, totaling approximately \$4,042,000 combined with typical portfolio fluctuations. Residential Real Estate loans increased \$1,127,000 to \$167,755,000 at June 30, 2016, as compared to \$166,628,000 at December 31, 2015. The increase was the result of \$13,523,000 in new loan originations offset by loan payoffs of \$5,417,000, net loans sold of \$1,260,000, and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the six months ended June 30, 2016 consisted of total loans sold during the six months ended June 30, 2016 of \$4,464,000, offset with loans opened and sold in the same quarter during any quarter of 2016 which amounted to \$3,204,000. 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 \$342,923,000 at June 30, 2016. Of total loans, \$263,524,000 or 51.0% were secured by commercial real estate, primarily lessors of residential buildings and dwellings and lessors of non-residential buildings. The Corporation continues to monitor these portfolios.

The largest relationship is comprised of various real estate entities with a mutual owner who began real estate investment and development activities in 1989. The relationship had outstanding loan balances and unused commitments of \$10,618,000 at June 30, 2016. The individual owns a diverse mix of real estate entities which specialize in construction/development projects, leasing of commercial office space, and rental of multi-tenant



residential units. This relationship is comprised of \$9,518,000 in term debt and two lines of credit totaling \$1,100,000. The relationship is well secured by first lien mortgages on income producing commercial and residential real estate, plus assignment of governmental leases and collateral pledge of cash accounts and marketable securities.

The second largest relationship is comprised of multiple first and second lien mortgages relating to the purchase and improvements of several existing hotels. The principal and related owners/guarantors have extensive experience in the hotel industry, owning and operating hotels in various states for over twenty-five years. At June 30, 2016, the relationship had outstanding loan balances and unused commitments of \$9,984,000. The debt is comprised of \$9,929,000 in term debt and two lines of credit totaling \$55,000. The loans are secured by commercial real estate and business assets.

The third largest relationship consists of a 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 \$8,492,000 at June 30, 2016. The debt is comprised of \$7,775,000 in term debt, \$450,000 in lines of credit, and \$267,000 in available credit on a real estate term loan. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

The fourth largest relationship consists of a municipality founded in 1816 consisting of 35 square miles. The township completed a major expansion of its central sewage system in late 2012 due to increasing population growth among residential users and the addition of a large volume of business users, including pharmaceutical companies and recreational waterparks. The expansion was funded by grants, bond issues, and bank debt. At June 30, 2016, the relationship had outstanding balances of \$8,474,000, which consisted entirely of term debt. The loans are secured by project receivables and the full faith, credit, and taxing power of the township.

The fifth largest relationship consists of a hotel management company that has been in operation since 1987 and successfully owns and operates seven hotels. At June 30, 2016, the relationship had outstanding balances totaling \$8,420,000, which consisted entirely of term debt. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

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

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

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$490,586,000 or 95.0% of gross loans are graded Pass; \$14,627,000 or 2.8% are graded Special Mention; \$11,155,000 or 2.2% 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 \$25,782,000 at June 30, 2016, as compared to \$23,264,000 at December 31, 2015. Commercial and Industrial non-pass grades increased to \$4,331,000 as of June 30, 2016 as compared to \$4,194,000 as of December 31, 2015. Commercial Real Estate non-pass grades increased to \$19,247,000 as of June 30, 2016 as compared to \$16,128,000 as of December 31, 2015. The Residential Real Estate and Consumer loan non-pass grades decreased to \$2,204,000 as of June 30, 2016 as compared to \$2,942,000 as of December 31, 2015.

The increase in Commercial Real Estate non-pass grades was mainly the result of the downgrade of one loan totaling \$3,630,000 (combined with typical payment amortization and other normal fluctuations in the Commercial Real Estate non-pass grade portfolio segment). The loan is a purchased participation to the owner of a recreation facility. The loan was downgraded to Special Mention during the first quarter of 2016 due to the borrower's decreased revenues which resulted from reduced snowfall totals and higher than average temperatures during the 2016 winter season.

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

**Total Loans**

| (Dollars in thousands)    | June 30,<br>2016 | December<br>31,<br>2015 |
|---------------------------|------------------|-------------------------|
| Commercial and Industrial | \$79,399         | \$85,074                |
| Commercial Real Estate    | 263,524          | 259,018                 |
| Residential Real Estate   | 167,755          | 166,628                 |
| Consumer                  | 6,320            | 5,890                   |
| Total loans               | \$516,998        | \$516,610               |

**ALLOWANCE FOR LOAN LOSSES**

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of June 30, 2016, the allowance for loan losses was \$7,219,000 as compared to \$6,739,000 as of December 31, 2015. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

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

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

The Analysis of Allowance for Loan Losses table contains an analysis of the allowance for loan losses indicating charge-offs and recoveries for the six month periods ended June 30, 2016 and 2015. For the first six months of 2016, net charge-offs as a percentage of average loans was 0.02% as compared to 0.04% for the six month period ended June 30, 2015. Net charge-offs amounted to \$87,000 for the first six months of 2016 as compared to \$215,000 for the first six months of 2015. The decrease in net charge-offs in the first six months of 2016 as compared to the first six months of 2015 related primarily to decreased charge-offs in Commercial and Residential Real Estate loans. During the first six months of 2016, \$82,000 in Commercial and Residential Real Estate loans were charged off as compared to the first six months of 2015 when \$245,000 in Commercial and Residential Real Estate loans were charged off.

For the first six months of 2016, the provision for loan losses was \$567,000 as compared to \$425,000 for the first six months of 2015. The provision, net of charge-offs and recoveries, increased the quarter end Allowance for Loan Losses to \$7,219,000 of which 9.7% was attributed to the Commercial and Industrial component; 55.6% attributed to the Commercial Real Estate component; 23.5% attributed to the Residential Real Estate component (primarily residential mortgages); 1.5% attributed to the Consumer component; and 9.7% being the unallocated component (refer to the activity in Note 4 – Loans and Allowance for Loan Losses on page 13). The Corporation determined that the provision for loan losses made during the current quarter was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of June 30, 2016.

### Analysis of Allowance for Loan Losses

| (Dollars in thousands)                       | June<br>30,<br>2016 | June<br>30,<br>2015 |
|--|---------------------|---------------------|
| Balance at beginning of the six month period | \$6,739             | \$6,390             |
| Charge-offs:                                 |                     |                     |
| Commercial and Industrial                    | 2                   | 2                   |
| Commercial Real Estate                       | 57                  | 137                 |
| Residential Real Estate                      | 25                  | 108                 |
| Consumer                                     | 23                  | 15                  |
|  | 107                 | 262                 |
| Recoveries:                                  |                     |                     |
| Commercial and Industrial                    | 4                   | 3                   |
| Commercial Real Estate                       |                     | 42                  |
| Residential Real Estate                      | 12                  |                     |
| Consumer                                     | 4                   | 2                   |

|   |         |         |  |  |
|---|---------|---------|--|--|
|   | 20      | 47      |  |  |
| Net charge-offs   | 87      | 215     |  |  |
| Additions charged to operations   | 567     | 425     |  |  |
| Balance at end of the six month period  | \$7,219 | \$6,600 |  |  |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.02 %  | 0.04 %  |  |  |
| Allowance for loan losses to average loans outstanding during the period                  | 1.39 %  | 1.31 %  |  |  |

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 1.39% at June 30, 2016 and 1.31% at June 30, 2015.

## NON-PERFORMING ASSETS

The table on page 42 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 \$4,249,000 as of June 30, 2016 as compared to \$4,386,000 as of December 31, 2015. The economy, in particular, high unemployment/labor underutilization rate, weak job markets, unsettled fuel prices and energy costs, and the continued slowness in the housing industry had a direct effect on the Corporation's non-performing assets. The Corporation is closely monitoring its Commercial Real Estate portfolio because of the current economic environment. In particular, vacancy rates are rising, while property values in some markets have fallen. Non-accrual loans totaled \$2,538,000 as of June 30, 2016 as compared to \$2,748,000 as of December 31, 2015. Foreclosed assets held for resale amounted to \$1,280,000 at June 30, 2016 as compared to \$1,472,000 at December 31, 2015. Loans past-due 90 days or more and still accruing interest amounted to \$431,000 as of June 30, 2016 as compared to \$166,000 as of December 31, 2015. At June 30, 2016, loans past-due 90 days and still accruing interest consisted of one Commercial Real Estate loan and one Residential Real Estate loan. A sale is pending on part of the collateral securing the Commercial Real Estate loan, and a substantial paydown will be made on the loan when the sale is finalized; at that time, the loan will be brought to paid-current status. The borrower of the Residential Real Estate loan has filed bankruptcy, and loan payments are currently being held by a trustee until the bankruptcy plan has been finalized; upon finalization, the payments will be forwarded to the Bank, and the loan will be brought to paid-current status.

Non-performing assets to total loans was 0.8% at June 30, 2016 and December 31, 2015. Non-performing assets to total assets was 0.4% at June 30, 2016 and December 31, 2015. The allowance for loan losses to total non-performing assets was 169.9% as of June 30, 2016 as compared to 153.6% as of December 31, 2015. Additional detail can be

found on page 42 in the Non-Performing Assets and Impaired Loans table and page 24 in the Loans Receivable on Non-Accrual Status table. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Potential problem loans are defined as performing substandard loans which are not deemed to be impaired. These loans have characteristics that cause management to have doubts regarding the ability of the borrower to perform under present loan repayment terms and which may result in reporting these loans as non-performing loans in the future. Potential problem loans amounted to \$860,000 at June 30, 2016, compared to \$2,280,000 at December 31, 2015.

Impaired loans were \$13,329,000 at June 30, 2016 and \$13,367,000 at December 31, 2015. The largest impaired loan relationship at June 30, 2016 consisted of one performing loan to a student housing holding company in the amount of \$4,151,000, 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 collateral evaluation at June 30, 2016 carried a value of \$3,896,000, after considering appraisal adjustments and costs to sell of 10% and considering the outstanding note balance, resulting in a specific allocation of \$256,000. At June 30, 2016, the second largest impaired loan relationship consisted of a performing loan to a developer of a residential sub-division in the amount of \$3,207,000, which was secured by commercial real estate. The contract was extended and the loan was modified as a TDR during the fourth quarter of 2015 because the weak real estate market has hindered the process of the development plans and expected sales of building lots have not materialized. The discounted cash flow evaluation at June 30, 2016 resulted in a specific allocation of \$0. The third largest impaired loan relationship at June 30, 2016 consisted of a non-performing participation loan to a student housing holding company which was secured by commercial real estate. The Corporation's participation share of the loan was \$968,000. The loan was downgraded to substandard and placed on non-accrual status during the third quarter of 2015 due to the borrower's inability to reach a break-even rental income, related to the borrower's failure to meet projected occupancy rates. The collateral evaluation of the total participation at June 30, 2016 carried a value of \$2,456,000, after considering estimated appraisal adjustments and costs to sell of 25% and considering the total participation outstanding note balance, resulting in a specific allocation of \$93,000. The estimated appraisal adjustments and cost to sell percentages are determined based on the market area in which the real estate securing the loan is located, among other factors, and therefore, can differ from one loan to another. Of the \$13,329,000 in impaired loans at June 30, 2016, none were located outside of the Corporation's primary market area.

Loans categorized as TDRs carried an unpaid balance of \$11,091,000 as of June 30, 2016 as compared to \$11,096,000 as of December 31, 2015. The small decrease in TDRs at June 30, 2016 as compared to December 31, 2015 is attributable to large principal payments and paydowns made on existing TDRs net against smaller loans modified as TDRs during the six months ended June 30, 2016. Of the twenty-nine restructured loans at June 30, 2016, seven loans are classified in the Commercial and Industrial portfolio and twenty-two loans are classified in the Commercial Real Estate portfolio. The troubled debt restructurings at June 30, 2016 consisted of sixteen term modifications beyond the original stated term, four interest rate modifications, and nine payment modifications. TDRs are separately identified for impairment disclosures, and if necessary, a specific allocation is established. As of June 30, 2016 and December 31, 2015, specific allocations of \$256,000 and \$309,000 were attributable to the TDRs. There were \$18,000 and \$31,000 in unused commitments attributable to TDRs at June 30, 2016 and December 31, 2015, respectively.

At June 30, 2016, five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$748,000 were not in compliance with the terms of their restructure, compared to June 30, 2015 when five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$6,393,000 were not in compliance with the terms of their restructure. The significant decrease in TDRs not in compliance with the terms of their restructure at June 30, 2016 as compared to June 30, 2015 is largely due to the proper measures being taken to bring two loans totaling \$5,639,000 into compliance with the terms of their restructure. One loan to a student housing holding company in the amount of \$4,226,000 was not in compliance with the terms of its restructure at June 30, 2015, but proper measures were taken to bring the loan into compliance with restructure terms by June 30, 2016. A purchased participation loan in the amount of \$1,413,000 to a distributor of recreational vehicles was not in compliance with the terms of its restructure at June 30, 2015. A piece of property related to this loan, valued at \$925,000, was moved to foreclosed assets held for resale at December 31, 2015, and proper measures were taken to bring the remainder of the loan into compliance with restructure terms by June 30, 2016.

During the three months ended June 30, 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same period in 2015 when one Commercial Real Estate loan totaling \$4,226,000 that was modified as a TDR within the preceding twelve months had experienced a payment default. During the six months ended June 30, 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same period in 2015 when two Commercial Real Estate loans totaling \$4,446,000 that were modified as TDRs within the preceding twelve months had experienced payment defaults. The significant decrease in defaulted TDRs at June 30, 2016 as compared to June 30, 2015 is largely due to one loan in the amount of \$4,226,000 to a student housing holding company, which was modified as a TDR in the first quarter of 2015 and experienced its subsequent payment default during the second quarter of 2015.

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



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

Improving loan quality is a priority. The Corporation actively works with borrowers to resolve credit problems and will continue its close monitoring efforts in 2016. Excluding the assets disclosed in the Non-Performing Assets and Impaired Loans tables below and the Troubled Debt Restructurings section in Note 4 — Loans and Allowance for Loan Losses, management is not aware of any information about borrowers' possible credit problems which cause serious doubt as to their ability to comply with present loan repayment terms.

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

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

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of June 30, 2016 and December 31, 2015, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

| (Dollars in thousands)                                       | June 30,<br>2016 | December<br>31,<br>2015 |       |   |
|--|------------------|-------------------------|-------|---|
| Non-performing assets  |                  |                         |       |   |
| Non-accrual loans  | \$2,538          | \$ 2,748                |       |   |
| Foreclosed assets held for resale                            | 1,280            | 1,472                   |       |   |
| Loans past-due 90 days or more and still accruing interest   | 431              | 166                     |       |   |
| Total non-performing assets                                  | \$4,249          | \$ 4,386                |       |   |
| Impaired loans   |                  |                         |       |   |
| Non-accrual loans  | \$2,538          | \$ 2,748                |       |   |
| Accruing TDRs  | 10,791           | 10,619                  |       |   |
| Total impaired loans   | 13,329           | 13,367                  |       |   |
| Allocated allowance for loan losses                          | (412 )           | (340 )                  |       |   |
| Net investment in impaired loans                             | \$12,917         | \$ 13,027               |       |   |
| Impaired loans with a valuation allowance                    | \$5,636          | \$ 4,640                |       |   |
| Impaired loans without a valuation allowance                 | 7,693            | 8,727                   |       |   |
| Total impaired loans   | \$13,329         | \$ 13,367               |       |   |
| Allocated valuation allowance as a percent of impaired loans | 3.1              | %                       | 2.5   | % |
| Impaired loans to total loans                                | 2.6              | %                       | 2.6   | % |
| Non-performing assets to total loans                         | 0.8              | %                       | 0.8   | % |
| Non-performing assets to total assets                        | 0.4              | %                       | 0.4   | % |
| Allowance for loan losses to impaired loans                  | 54.2             | %                       | 50.4  | % |
| Allowance for loan losses to total non-performing assets     | 169.9            | %                       | 153.6 | % |

Real estate mortgages comprise 83.4% of the loan portfolio as of June 30, 2016, as compared to 82.4% as of December 31, 2015. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation's market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation's market

area. The Corporation's loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

## DEPOSITS AND OTHER BORROWED FUNDS

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

Total deposits decreased \$36,127,000 to \$684,471,000 as of June 30, 2016 as non-interest bearing deposits increased by \$1,722,000 and interest bearing deposits decreased by \$37,849,000 from year-end 2015. Total deposits decreased due to the withdrawal of funds by a municipal depositor through normal, seasonal use of funds. The shift to core deposits and away from time deposits continued in the six months ended June 30, 2016. Demand deposits and savings accounts increased, while certificates of deposit fell. Total short-term and long-term borrowings increased to \$174,813,000 as of June 30, 2016, from \$150,771,000 at year-end 2015, an increase of \$24,042,000, or 15.9%. Total borrowings increased due to decreased deposit balances.

## CAPITAL STRENGTH

Normal increases in capital are generated by net income, less dividends paid out. During the first six months of the year, net income less dividends paid increased capital by \$1,629,000. Accumulated other comprehensive income derived from net unrealized gains on investment securities available-for-sale also impacts capital. At December 31, 2015, accumulated other comprehensive income was \$2,035,000. Accumulated other comprehensive income stood at \$8,633,000 at June 30, 2016, an increase of \$6,598,000. Fluctuations in interest rates have regularly impacted the gain/loss position in the Bank's investment portfolio, as well as its decision to sell securities at a gain or loss. In order to protect the Bank from market risk in the event of further interest rate increases, the Bank chose to sell a portion of its securities during the first six months of 2016 at an overall net gain of \$394,000. These fluctuations from net unrealized gains on investment securities available-for-sale do not affect regulatory capital, as the Bank elected to opt-out of this item with the filing of the March 31, 2015 Call Report.

The Corporation held 233,112 shares of common stock as treasury stock at June 30, 2016 and December 31, 2015. This had an effect of reducing our total stockholders' equity by \$5,756,000 as of June 30, 2016 and December 31, 2015.

Total stockholders' equity was \$117,336,000 as of June 30, 2016, and \$108,438,000 as of December 31, 2015. Leverage ratio and risk based capital ratios remain very strong. As of June 30, 2016, the Bank's Tier 1 leverage ratio was 8.56% compared to 8.46% as of December 31, 2015. Tier I risk based capital and total risk based capital ratios as of June 30, 2016, were 12.80% and 13.95%, respectively. The same ratios as of December 31, 2015 were 12.67% and 13.76%, respectively. In addition, the Bank's Common Equity Tier 1 capital to risk-weighted assets ratio was 12.80% at June 30, 2016 and 12.67% at December 31, 2015.

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of June 30, 2016, 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.

## LIQUIDITY

The Corporation's objective is to maintain adequate liquidity to meet funding needs at a reasonable cost and to provide contingency plans to meet unanticipated funding needs or a loss of funding sources, while minimizing interest rate risk. Adequate liquidity provides resources for credit needs of borrowers, for depositor withdrawals and for funding corporate operations.

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; and,
- Borrowing capacity available from correspondent banks: FHLB, Atlantic Community Bankers Bank and Federal Reserve Bank.

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 deposits are stable even in periods of changing interest rates. Liquidity and funds management are governed by policies and are measured on a monthly basis. These measurements indicate that liquidity generally remains stable and exceeds the Corporation's minimum defined levels of adequacy. Other than the trends of continued competitive pressures and volatile interest rates, there are no known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, liquidity increasing or decreasing in any material way.

## MARKET RISK

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

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

### *Asset/Liability Management*

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive at June 30, 2016.

### *Earnings at Risk*

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

continues to measure its interest rate sensitivity gap, the Corporation utilizes additional modeling for interest rate risk in the overall balance sheet. Earnings at risk and economic values at risk are analyzed.

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

### *Earnings Simulation Modeling*

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

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

The table on the bottom of this page presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from various increases or decreases in the level of interest rates, such as two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease 4.0%, 8.5% and 13.6% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would decrease 1.7% and 7.3% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 25 – 50 basis point range. Results of the decreasing basis point declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the six months ended June 30, 2016, the cost of interest-bearing liabilities averaged 0.69%, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 3.75%.

### *Net Present Value Estimation*

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At June 30, 2016, the 100 and 200 basis point immediate decreases in rates are estimated to affect tax-adjusted net present value with decreases of 6.0% and 15.0%, respectively. Additionally, tax-adjusted net present value is projected to decrease 0.0%, 2.0% and 6.1% 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 contemplate actions management could undertake in response to changes in interest rates.

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

|                               | Projected Change |
|-------------------------------|------------------|
| Effect on Net Interest Income |                  |



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|  |       |    |
|--|-------|----|
| 1-Year Net Income Simulation Projection      |       |    |
| +300 bp Shock vs. Stable Rate                | (13.6 | )% |
| +200 bp Shock vs. Stable Rate                | (8.5  | )% |
| +100 bp Shock vs. Stable Rate                | (4.0  | )% |
| Flat rate                                    |       |    |
| -100 bp Shock vs. Stable Rate                | (1.7  | )% |
| -200 bp Shock vs. Stable Rate                | (7.3  | )% |
| Effect on Net Present Value of Balance Sheet |       |    |
| Static Net Present Value Change              |       |    |
| +300 bp Shock vs. Stable Rate                | (6.1  | )% |
| +200 bp Shock vs. Stable Rate                | (2.0  | )% |
| +100 bp Shock vs. Stable Rate                |       |    |
| Flat rate                                    |       |    |
| -100 bp Shock vs. Stable Rate                | (6.0  | )% |
| -200 bp Shock vs. Stable Rate                | (15.0 | )% |

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

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

### Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified a) in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer of the Corporation concluded that the Corporation's disclosure controls and procedures were effective as of June 30, 2016.

Changes in internal control over financial reporting. There were no changes in the Corporation's internal control b) over financial reporting during the fiscal quarter ended June 30, 2016, that materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## PART II - OTHER INFORMATION

## Item 1. Legal Proceedings

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

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A “Risk Factors” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015.

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

| Period                      | (a)<br>Total Number of<br>Shares Purchased | (b)<br>Average Price Paid<br>per Share | (c)<br>Total Number of Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs | (d)<br>Maximum Number of<br>Shares that May Yet Be<br>Purchased Under the<br>Plans or Programs |
|-----------------------------|--|--|--|--|
| April 1 —<br>April 30, 2016 |  |  |  | 120,000  |
| May 1 —<br>May 31, 2016     |  |  |  | 120,000  |
| June 1 —<br>June 30, 2016   |  |  |  | 120,000  |
| Total                       |  |  |  | 120,000  |

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits and Reports on Form 8-K

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

| Exhibit Number | Description of Exhibit  |
|----------------|---|
| 3i             | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10-Q for the quarter ended June 30, 2012).                          |
| 3ii            | By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated February 14, 2013).   |
| 10.1(a)        | Supplemental Employee Retirement Plan – J. Gerald Bazewicz (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*  |
| 10.1(b)        | Supplemental Employee Retirement Plan – David R. Saracino (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*   |
| 10.1(c)        | Supplemental Employee Retirement Plan – Matthew P. Prosseda (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).* |
| 10.1(d)        | Supplemental Employee Retirement Plan – Elaine Woodland (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*     |
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| 10.4           | First Keystone Corporation 1998 Stock Incentive Plan (Incorporated by reference to Exhibit 10 to Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).*           |
| 14             | First Keystone Corporation Directors and Senior Management Code of Ethics (Incorporated by reference to Exhibit 14 to Registrant's Report on Form 8-K dated August 27, 2013).           |
| 31.1           | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.**  |
| 31.2           | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.**  |
| 32.1           | Section 1350 Certification of Chief Executive Officer.**  |
| 32.2           | Section 1350 Certification of Chief Financial Officer.**  |
| 101.INS        | XBRL Instance Document.**   |
| 101.SCH        | XBRL Taxonomy Extension Schema Document.**  |

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.\*\*

101.DEF XBRL Taxonomy Extension Definition Linkbase Document.\*\*

101.LAB XBRL Taxonomy Extension Label Linkbase Document.\*\*

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.\*\*

\*Denotes a compensatory plan.

\*\*Filed herewith.

The Corporation will provide a copy of any exhibit upon receipt of a written request for the particular exhibit or exhibits desired. All requests should be addressed to the Corporation's principal executive offices.

FIRST KEYSTONE CORPORATION

SIGNATURES

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

FIRST KEYSTONE CORPORATION  
Registrant

August 8, 2016 /s/ Matthew P. Prosseda  
Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

August 8, 2016 /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

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