FIRST KEYSTONE CORP
Form 10-K
March 18, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended **December 31, 2012**

or

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

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its Charter)

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

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

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

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

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

Yes ¨ No x

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

Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted 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 x No ¨

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

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

The aggregate market value of the registrant's outstanding voting common stock held by non-affiliates on June 30, 2012 determined by using a per share closing price on that date of $23.81 as quoted on the Over the Counter Bulletin Board, was $117,130,819.

At March 1, 2013 there were 5,480,217 shares of Common Stock, $2.00 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's 2013 definitive Proxy Statement are incorporated by reference in Part III of this Report.

FIRST KEYSTONE CORPORATION

FORM 10-K

Table of Contents

		Page
Part I		
Item 1.	Business	1
Item 1A.	Risk Factors	11
Item 1B.	Unresolved Staff Comments	15
Item 2.	Properties	16
Item 3.	Legal Proceedings	16
Item 4.	Mine Safety Disclosures	16
Part II		
Item 5.	Market for Registrant’s Common Equity and Related Shareholder Matters and Issuer Purchases of Equity Securities	17
Item 6.	Selected Financial Data	20
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Item 7A.	Quantitative and Qualitative Disclosure About Market Risk	40
Item 8.	Financial Statements and Supplementary Data	41
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	86
Item 9A.	Controls and Procedures	86
Item 9B.	Other Information	86
Part III		
Item 10.	Directors, Executive Officers and Corporate Governance	87
Item 11.	Executive Compensation	87
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	87
Item 13.	Certain Relationships and Related Transactions, and Director Independence	88
Item 14.	Principal Accountant Fees and Services	88
Part IV		
Item 15.	Exhibits and Financial Statement Schedules	88
Signatures		90

FIRST KEYSTONE CORPORATION

FORM 10-K

PART I

Forward Looking Statements

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

Forward-looking statements are subject to certain risks and uncertainties such as local economic conditions, competitive factors, and regulatory limitations. Actual results may differ materially from those projected in the forward-looking statements. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: ineffectiveness of the business strategy due to changes in current or future market conditions; the effects of economic deterioration on current customers, specifically the effect of the economy on loan customers' ability to repay loans; the effects of competition, changes in laws and regulation, including the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated thereunder; interest rate movements; information technology difficulties, and challenges in establishing and maintaining operations in new markets; volatilities in the securities markets; and deteriorating economic conditions.

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

ITEM 1. BUSINESS

General

First Keystone Corporation (the "Corporation") is a Pennsylvania business corporation, and a bank holding company, registered with and supervised by the Board of Governors of the Federal Reserve System. The Corporation was incorporated on July 6, 1983, and commenced operations on July 2, 1984, upon consummation of the acquisition of all of the outstanding stock of First National Bank of Berwick (the predecessor to First Keystone Community Bank). The Corporation has one wholly-owned subsidiary, First Keystone Community Bank (the "Bank"), which has a commercial banking operation and trust department as its major lines of business. Since commencing operations, the Corporation's business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank. Greater than 98% of the Corporation's revenue and profit came from the commercial bank subsidiary for the years ended December 31, 2012, 2011, and 2010, and was the only reportable segment. At December 31, 2012, the Corporation had total consolidated assets, deposits and stockholders' equity of approximately $820 million, $609 million and $103 million, respectively.

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

Effective November 1, 2007, the Corporation completed its acquisition of Pocono Community Bank through the merger of Pocono with and into the Bank. On the acquisition date, Pocono Community Bank had approximately $150 million in assets, $105 million in loans and $110 million in deposits. Headquartered in Stroudsburg, Pennsylvania, and organized in 1996, Pocono had 4 banking offices located in Monroe County, Pennsylvania. The acquisition expanded the branch network of the Corporation and provides Pocono customers with a broader array of products and services.

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

The Bank's legal headquarters are located at 111 West Front Street, Berwick, Pennsylvania, from which it oversees the operations of its sixteen branch locations. These locations consist of five branches within Columbia County, six branches within Luzerne County, one branch in Montour County, and four branches within Monroe County, Pennsylvania. For further information, please refer to Item 2 – Properties, and Note 14 – Commitments and Contingencies in the notes to the consolidated financial statements.

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

At December 31, 2012, the Bank had 180 full-time employees and 26 part-time employees. In the opinion of management, the Bank enjoys a satisfactory relationship with its employees. The Bank is not a party to any collective bargaining agreement.

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

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

Primary Market Areas

The Bank’s primary market area reaches from Monroe and Montour counties along the Interstate 80 corridor through parts of Columbia and Luzerne counties as well as other adjoining counties. The Bank’s eastern market area is centered in Stroudsburg, Pennsylvania and serves all of Monroe county, as well as adjoining counties of Pike and Northampton. The area served by the Bank is a mix of rural communities and small to mid-sized towns. The current population of the Bank’s primary four-county footprint has grown 0.5% since 2010 to 579,000 and is estimated to increase 0.8% to 584,000 by 2017. As of June 30, 2012, the FDIC deposit market share data ranked the Bank 6th in the deposit market share in the four-county market, with 6.57% of deposits.

The Bank’s headquarters, main office, and three of its branch offices are located in Berwick, Pennsylvania. Therefore, the Bank has a very strong presence in the Borough of Berwick, a community with a current population of approximately 10,000. The Bank ranks a commanding first in deposit market share in the Berwick market with 72.63% of deposits as of June 30, 2012, based on data compiled annually by the FDIC.

In the course of attracting and retaining deposits and originating loans, the Bank faces considerable competition. The Bank competes with 36 commercial banks, 5 savings associations, and 21 credit unions for traditional banking products, such as deposits and loans in its primary four-county market area. Additionally, the Bank competes with consumer finance companies for loans, mutual funds and other investment alternatives for deposits. The Bank competes for deposits based on the ability to provide a range of competitively priced products, quality service, competitive rates, and convenient locations and hours. The competition among its peers for loan origination generally relates to interest rates offered, products available, ease of process, quality of service, and loan origination fees charged. The economic base of the Bank's market region is developed around small business, health care, educational facilities (college and public schools), light manufacturing industries, and agriculture.

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

Competition - Bank

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

- First Columbia Bank & Trust Co. of Bloomsburg
- PNC Bank, N.A.
- M & T Bank
- FNB Bank, N.A.
- Wells Fargo Bank
- National Penn Bank
- Citizens Bank
- ESSA Bank & Trust
- First National Community Bank
- Service 1st FCU
- Jersey Shore State Bank
- Bank of America

The Bank competes with a number of credit unions, especially in Luzerne and Montour counties. The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

Concentration

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

Supervision and Regulation

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

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

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

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

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

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

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

Permitted Non-Banking Activities

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

Legislation and Regulatory Changes

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

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

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

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

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

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 4%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under the FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category. On December 31, 2012, the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category. See Note 16 — Regulatory Matters.

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

Other Provisions of the FDICIA

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

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

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

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

companies. Operational and managerial standards must relate to:

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

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

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

Regulatory Capital Requirements

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

The following table presents the Corporation's capital ratios at December 31, 2012.

	(In Thousands)	
Tier I Capital	$ 70,955	
Tier II Capital	5,972	
Total Capital	$ 76,927	
Adjusted Total Average Assets	$ 791,434	
Total Adjusted Risk-Weighted Assets[1]	$ 532,112	
Tier I Risk-Based Capital Ratio[2]	13.33	%
Required Tier I Risk-Based Capital Ratio	4.00	%
Excess Tier I Risk-Based Capital Ratio	9.33	%
Total Risk-Based Capital Ratio[3]	14.46	%
Required Total Risk-Based Capital Ratio	8.00	%
Excess Total Risk-Based Capital Ratio	6.46	%
Tier I Leverage Ratio[4]	8.97	%
Required Tier I Leverage Ratio	4.00	%
Excess Tier I Leverage Ratio	4.97	%

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

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

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

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

The Corporation's ability to maintain the required levels of capital is substantially dependent upon the success of the Corporation's capital and business plans; the impact of future economic events on the Corporation's loan customers; and the Corporation's ability to manage its interest rate risk and investment portfolio and control its growth and other operating expenses. See also, the information under Capital Strength in Management's Discussion and Analysis on page 34 of this report.

Proposed Regulatory Capital Changes

In June 2012, the Federal Reserve Bank, the FDIC and the Office of the Comptroller of the Currency issued proposed rules that would revise bank regulatory capital requirements and the risk-weighted asset rules. These rules represent the most extensive changes to bank capital requirements in the recent past. The rules will extend large parts of a regulatory capital administration to all U.S. banks and their holding companies, other than the smallest bank holding companies (generally, those with under $500 million in consolidated assets). The implementation of the rules has been delayed several times and it is uncertain when they will go into effect at this time. Below is a summary:

Summary of proposed rules for capital:

- Revise the definition of regulatory capital components and related calculations, which would include conservative guidelines for determining whether an instrument could qualify as regulatory capital;
- Add common equity Tier 1 capital as a new regulatory capital component;
- Increase the minimum Tier 1 capital ratio requirement;
- Create a capital conservation buffer that would limit payment of capital distributions and certain discretionary bonus payments to executive officers if the institution does not hold enough common equity Tier 1 capital;
- Provide for a transition period for several aspects of the rule; and
- Incorporate the new and revised regulatory capital requirements into the Prompt Corrective Action rules.

Summary of proposed rules for risk-weighted assets:

The proposal would expand the number of risk-weighted categories and increase the required capital for certain categories of assets, including higher-risk residential mortgages and higher-risk construction real estate loans. In addition, the rule would:

- Revise risk weights for residential mortgages based on LTV ratios and certain loan characteristics, assigning risk weights between 35% and 200%;
- Increase capital requirements for past due loans from 100% to 150% and set the risk weight for high volatility commercial real estate loans at 150%; and
- Revise the risk-weighted percentage for unused commitments with an original maturity of one year or less from 0% to 20% unless the commitment is unconditionally cancelable by the bank.

The risk-weighted asset rule will apply to all U.S. banks and savings banks and almost all of their holding companies, although smaller, "non-complex" banking organizations will not need to comply with some of the rule's requirements. The Corporation is in the process of assessing the impact of these proposed changes on the regulatory ratios of the Corporation and the Bank on the capital, operations, liquidity and earnings of the Corporation and Bank.

Effect of Government Monetary Policies

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

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

Effects of Inflation

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

Environmental Regulation

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

Interest Rate Risk

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

JOBS Act

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the "JOBS Act") into law. The JOBS Act is aimed at facilitating capital raising by smaller companies, banks and bank holding companies by implementing the following changes:

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

While the JOBS Act is not expected to have any immediate application to the Corporation, management will continue to monitor the implementation rules for potential effects which might benefit the Corporation.

The Gramm-Leach-Bliley Act of 2000

In 2000, the Gramm-Leach-Bliley Act became law, which is also known as the Financial Services Modernization Act. The act repealed some Depression-era banking laws and will permit banks, insurance companies and securities firms to engage in each others' businesses after complying with certain conditions and regulations. The act grants to community banks the power to enter new financial markets as a matter of right that larger institutions have managed to do on an ad hoc basis. At this time, the Corporation has no plans to pursue these additional possibilities.

The Sarbanes-Oxley Act

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

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

8

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

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

Dodd-Frank Wall Street Reform and Consumer Protection Act

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

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

Deposit Insurance. Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, and extends unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from

1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, Dodd-Frank eliminates the federal statutory prohibition against the payment of interest on business checking accounts.

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

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

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

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

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

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

to foreclosure if they receive any loan other than a “qualified mortgage” as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Available Information

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

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

ITEM 1A. RISK FACTORS

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

The Corporation is subject to interest rate risk.

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

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

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

If adopted as proposed, Basel III targets higher levels of base capital, certain capital buffers and a migration toward common equity as the key source of regulatory capital. Although the new capital requirements are phased in over the next decade and may change substantially before final implementation, Basel III signals a growing effort by domestic and international bank regulatory agencies to require financial institutions, including depository institutions, to maintain higher levels of capital. The direction of the Basel III implementation activities or other regulatory viewpoints could require additional capital to support its business risk profile prior to final implementation of the Basel III standards. If the Corporation and the Bank are required to maintain higher levels of capital, the Corporation

and the Bank may have fewer opportunities to invest capital into interest-earning assets, which could limit the profitable business operations available to the Corporation and the Bank and adversely impact its financial condition and results of operations.

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

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

A breach of information security could negatively affect the Corporation's earnings.

Increasingly, the Corporation depends upon data processing, communication and information exchange on a variety of computing platforms and networks, and over the Internet. The Corporation has policies and procedures, security applications and fraud mitigation applications designed to prevent or limit the effect of a failure, interruption, security breach or fraud attack on our information systems. The Corporation cannot be certain its systems are entirely free from vulnerability to attack, despite safeguards we have instituted. In addition, the Corporation relies on the services of a variety of vendors to meet its data processing and communication needs. Disruptions to its vendors' systems may arise from events that are wholly or partially beyond its vendors' control (including, for example, computer viruses or electrical or telecommunications outages). If information security is breached, despite the controls the Corporation and its third party vendors have instituted, information can be lost or misappropriated, resulting in financial loss or costs to the Corporation or damages to others. These costs or losses could materially exceed the amount of insurance coverage, if any, which would adversely affect its earnings. In addition, its reputation could be damaged which could result in loss of customers, greater difficulty in attracting new customers, or an adverse effect on the value of its common stock.

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

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

The Corporation operates in a highly competitive industry.

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

structures.

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

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

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

The Corporation is subject to extensive government regulation and supervision.

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

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

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

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

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

The Corporation is subject to lending risk.

As of December 31, 2012, approximately 64.5% of the Corporation's loan portfolio consisted of commercial and industrial, construction and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Corporation's loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's financial condition and results of operations.

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

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

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

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

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

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

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

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

The Corporation's loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In determining the amount of the allowance for loan losses, the Corporation reviews its loans and its loss and delinquency experience, and the Corporation evaluates economic conditions. If its assumptions prove to be incorrect, its allowance for loan losses may not cover inherent losses in its loan portfolio at the date of its financial statements. Material additions to the Corporation's allowance would materially decrease its net income. At December 31, 2012, its allowance for loan losses totaled $5.8 million, representing 1.36% of its average total loans.

Although the Corporation believes it has underwriting standards to manage normal lending risks, it is difficult to assess the future performance of its loan portfolio due to the relatively recent origination of many of these loans. The Corporation cannot assure that its non-performing loans will not increase or that its non-performing or delinquent loans will not adversely affect its future performance.

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

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

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

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

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

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

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

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

ITEM 1B.   UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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

Properties owned are:

- Main Office located at 111-119 West Front Street, Berwick, Pennsylvania 18603;
- Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;
- Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
- Scott Township Office located at 2301 Columbia Boulevard, Bloomsburg, Pennsylvania 17815;
- Mifflinville Office located at Third and Race Streets, Mifflinville, Pennsylvania 18631;
- Hanover Township Office located at 1540 Sans Souci Highway, Wilkes-Barre, Pennsylvania 18706;
- Danville Office located at 1519 Bloom Road, Danville, Pennsylvania 17821;
- Mountainhome Office located at 154 Route 390, Mountainhome, Pennsylvania 18342;
- Brodheadsville Office located at Route 209, Brodheadsville, Pennsylvania 18322;
- Swiftwater Office located at 2070 Route 611, Swiftwater, Pennsylvania 18370;
- Plymouth Office located at 463 West Main Street, Plymouth, Pennsylvania 18651;
- Kingston Office located at 299 Wyoming Avenue, Kingston, Pennsylvania 18704;
- Dallas Office located at 225 Memorial Highway, Dallas, Pennsylvania 18612 (See Note 14);
- Shickshinny property located at 107 South Main Street, Shickshinny, Pennsylvania 18655 (See Note 14);
- Properties located at Second and Market Streets, and Third and Bowman Streets, Berwick, Pennsylvania 18603; and
- 17 ATMs located in Columbia, Luzerne, Montour and Monroe counties.

Properties leased are:

- Briar Creek Office located inside the Giant Market at 50 Briar Creek Plaza, Berwick, Pennsylvania 18603;
- Nescopeck Office located at 437 West Third Street, Nescopeck, Pennsylvania 18635;
- Stroudsburg Office located at 559 Main Street, Stroudsburg, Pennsylvania 18360;
- Operations Center located at 105 Market Street, Berwick, Pennsylvania 18603; and
- Mountain Top Office located at 18 North Mountain Boulevard, Mountain Top, Pennsylvania 18707 (land parcel is leased and the bank building is owned).

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

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

- The quarterly high and low prices for a share of the Corporation's common stock during the periods indicated as reported to the management of the Corporation;
- Quarterly dividends on a share of the common stock paid with respect to each quarter since January 1, 2011; and
- The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

MARKET VALUE OF COMMON STOCK

	High	Low	Per Share Dividend Paid
2012:			
First quarter	$ 23.00	$ 19.75	$ .25
Second quarter	$ 26.00	$ 22.30	$ .25
Third quarter	$ 25.49	$ 24.00	$ .25
Fourth quarter	$ 25.20	$ 23.71	$ .26
2011:			
First quarter	$ 18.05	$ 16.85	$ .24
Second quarter	$ 19.75	$ 17.30	$ .24
Third quarter	$ 20.50	$ 18.55	$ .24
Fourth quarter	$ 20.50	$ 18.50	$ .25

As of December 31, 2012, the Corporation had approximately 905 shareholders of record.

The Corporation has paid dividends since commencement of business in 1984. It is the present intention of the Corporation's Board of Directors to continue the dividend payment policy; however, further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors relevant at the time the Board of Directors of the Corporation considers its dividend policy. Cash available for dividend distributions to shareholders of the Corporation must initially come from dividends paid by the Bank to the Corporation. Therefore,

the restrictions on the Bank's dividend payments are directly applicable to the Corporation.

Transfer Agent:

Registrar and Transfer Company	(800) 368-5948
10 Commerce Drive	
Cranford, NJ 07016-3752	

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

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

Dividend Restrictions on the Bank

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

Dividend Restrictions on the Corporation

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

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

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

- Financial statements prepared on the basis of generally accepted accounting principles;
- Financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances; or
- A fair valuation or other method that is reasonable under the circumstances.

PERFORMANCE GRAPH

The following graph and table compare the cumulative total shareholder return on the Corporation's common stock during the period December 31, 2007, through and including December 31, 2012, with

- The cumulative total return on the SNL Securities Corporate Performance Index[1] for banks $500 million to $1 billion in total assets in the Middle Atlantic area[2], and
- The cumulative total return for all United States stocks traded on the NASDAQ Stock Market.

The comparison assumes $100 was invested on December 31, 2007, in the Corporation's common stock and in each of the indices below and assumes further the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance.

FIRST KEYSTONE CORPORATION

Total Return Performance

	Period Ending					
	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
First Keystone Corporation	100.00	97.01	120.50	131.19	161.78	200.16
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
SNL Bank $500M- $1B	100.00	64.08	61.03	66.62	58.61	75.14

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

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

ITEM 6. SELECTED FINANCIAL DATA

(Amounts in thousands, except per share)

	Year Ended December 31,				
	2012	2011	2010	2009	2008
SELECTED FINANCIAL DATA:					
Total assets	$819,966	$818,546	$796,601	$758,330	$714,898
Total investment securities	303,756	336,618	316,531	282,798	243,165
Net loans	427,124	410,066	403,950	401,375	403,172
Total deposits	608,834	624,349	626,895	580,569	504,633
Total long-term borrowings	44,520	64,339	66,400	82,976	82,062
Total stockholders' equity	103,330	93,092	79,060	74,167	69,147
SELECTED OPERATING DATA:					
Interest income	$34,936	$37,028	$38,154	$37,726	$37,638
Interest expense	6,514	9,405	12,742	15,565	18,116
Net interest income	28,422	27,623	25,412	22,161	19,522
Provision for loan losses	1,600	1,900	2,575	800	700
Net interest income after provision for loan losses	26,822	25,723	22,837	21,361	18,822
Non-interest income	5,933	4,431	5,758	4,299	4,046
Non-interest expense	20,398	17,695	17,272	16,444	13,923
Income before income tax expense	12,357	12,459	11,323	9,216	8,945
Income tax expense	2,187	2,552	2,362	1,279	1,394
Net income	$10,170	$9,907	$8,961	$7,937	$7,551
PER SHARE DATA:					
Net income	$1.86	$1.82	$1.65	$1.46	$1.39
Cash dividends	1.01	.97	.93	.92	.89
PERFORMANCE RATIOS:					
Return on average assets	1.25 %	1.21 %	1.09 %	1.06 %	1.08 %
Return on average equity	10.19 %	11.57 %	10.98 %	10.88 %	10.72 %
Dividend payout	54.18 %	53.31 %	56.47 %	63.06 %	64.12 %
Average equity to average assets	12.28 %	10.43 %	9.95 %	9.73 %	10.00 %

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

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

RESULTS OF OPERATIONS

Year Ended December 31, 2012 Versus Year Ended December 31, 2011

Net income increased to $10,170,000 for the year ended December 31, 2012, as compared to $9,907,000 for the prior year, an increase of 2.7%. Earnings per share, both basic and diluted, for 2012 were $1.86 as compared to $1.82 in 2011, an increase of 2.2%. Cash dividends per share increased to $1.01 in 2012 from $.97 in 2011, an increase of 4.1%. The Corporation's return on average assets was 1.25% in 2012 as compared to 1.21% in 2011. Return on average equity decreased to 10.2% in 2012 from 11.6% in 2011. Falling yields and a slight decrease in earning asset levels resulted in an overall decrease of interest income to $34,936,000, down $2,092,000 or 5.7% from 2011. There was the accompanying decrease in interest on deposits and borrowings as interest rates declined, which resulted in interest expense of $6,514,000 in 2012, a decrease of $2,891,000 or 30.7% from 2011.

In July 2012, the Corporation completed transactions designed to improve net interest income. Investment securities with a market value of $15,941,000 and having a yield of 2.95% were sold for a gain of $946,000. In addition, term borrowings with the Federal Home Loan Bank of Pittsburgh in the amount of $13,750,000 with a weighted average cost of 4.29% were prepaid, resulting in a prepayment penalty of $811,000. The impact of these transactions was an annualized increase in net interest income of $150,000. The deleveraging of the balance sheet also improved Tier 1 leverage and improved sensitivity to rising interest rates.

Net interest income, as indicated below in Table 1, increased by $799,000 or 2.9% to $28,422,000 for the year ended December 31, 2012. The Corporation's net interest income on a fully taxable equivalent basis increased by $1,185,000, or 4.0% to $31,082,000 in 2012 as compared to an increase of $2,663,000, or 9.8% to $29,897,000 in 2011.

Year Ended December 31, 2011 Versus Year Ended December 31, 2010

Net income increased to $9,907,000 for the year ended December 31, 2011, as compared to $8,961,000 for the prior year, an increase of 10.6%. Earnings per share, both basic and diluted, for 2011 were $1.82 as compared to $1.65 in

2010, an increase of 10.3%. Cash dividends per share increased to $.97 in 2011 from $.93 in 2010, an increase of 4.3%. The Corporation's return on average assets was 1.21% in 2011 as compared to 1.09% in 2010. Return on average equity increased to 11.6% in 2011 from 11.0% in 2010. Falling yields and a slight decrease in earning asset levels resulted in an overall decrease of interest income to $37,028,000, down $1,126,000 or 2.9% from 2010. There was the accompanying decrease in interest on deposits and borrowings as interest rates declined, which resulted in interest expense of $9,405,000 in 2011, a decrease of $3,337,000 or 26.2% from 2010.

Net interest income, as indicated below in Table 1, increased by $2,211,000 or 8.7% to $27,623,000 for the year ended December 31, 2011. The Corporation's net interest income on a fully taxable equivalent basis increased by $2,663,000, or 9.8% to $29,897,000 in 2011 as compared to 2010.

Table 1 — Net Interest Income

(Amounts in thousands)		2012/2011 Increase/(Decrease)			2011/2010 Increase/(Decrease)		
	2012	**Amount**	%	2011	Amount	%	2010
Interest Income	$34,936	$(2,092)	(5.7)	$37,028	$(1,126)	(2.9)	$38,154
Interest Expense	6,514	(2,891)	(30.7)	9,405	(3,337)	(26.2)	12,742
Net Interest Income	28,422	799	2.9	27,623	2,211	8.7	25,412
Tax Equivalent Adjustment	2,660	386	17.0	2,274	452	24.8	1,822
Net Interest Income (fully tax equivalent)	$31,082	$1,185	4.0	$29,897	$2,663	9.8	$27,234

Table 2 — Distribution of Assets, Liabilities and Stockholders' Equity

	2012 Average Balance	**Revenue/ Expense**	**Yield/ Rate**	2011 Average Balance	Revenue/ Expense	Yield/ Rate	2010 Average Balance	Revenue/ Expense	Yield/ Rate
Interest Earning Assets:									
Loans:									
Commercial, net[1,2]	**$47,386**	**$2,398**	**5.06 %**	$40,883	$2,214	5.42 %	$41,246	$2,307	5.59 %
Real Estate[1]	**369,674**	**19,538**	**5.29 %**	364,099	20,427	5.61 %	360,481	21,164	5.87 %
Consumer, net[1,2]	**6,520**	**517**	**7.93 %**	7,561	643	8.50 %	8,700	717	8.24 %
Fees on Loans	**0**	**650**	**0 %**	0	454	0 %	0	478	0 %
Total Loans (Including Fees)[3]	**$423,580**	**$23,103**	**5.45 %**	$412,543	$23,738	5.75 %	$410,427	$24,666	6.01 %
Investment Securities:									
Taxable	**$215,849**	**$8,028**	**3.72 %**	$234,410	$9,790	4.18 %	$225,670	$10,502	4.65 %
Tax Exempt[1]	**105,359**	**6,464**	**6.14 %**	87,427	5,769	6.60 %	72,477	4,780	6.60 %
Total Investment Securities	**321,208**	**14,492**	**4.51 %**	321,837	15,559	4.83 %	298,147	15,282	5.13 %
Interest Bearing Deposits in Banks	**2,791**	**1**	**0.04 %**	13,840	4	0.03 %	39,638	24	0.06 %
Federal Funds Sold	**0**	**0**	**0 %**	565	1	0.18 %	1,521	4	0.26 %
Total Other Interest Earning Assets	**2,791**	**1**	**0.04 %**	14,405	5	0.03 %	41,159	28	0.07 %
Total Interest Earning Assets	**$747,579**	**$37,596**	**5.03 %**	$748,785	$39,302	5.25 %	$749,733	$39,976	5.33 %
Non-Interest Earning Assets:									
Cash and Due From Banks	**$6,881**			$6,050			$3,980		
Allowance for Loan Losses	**(5,994)**			(5,711)			(5,286)		
Premises and Equipment	**15,978**			12,072			11,816		
Foreclosed Assets Held for Sale	**876**			1,208			466		
Other Assets	**47,660**			58,744			58,916		
Total Non-Interest Earning Assets	**65,401**			72,363			69,892		
Total Assets	**$812,980**			$821,148			$819,625		
Interest Bearing Liabilities:									
Savings, NOW Accounts, and Money Markets	**$289,399**	**$762**	**0.26 %**	$308,778	$1,721	0.56 %	$288,431	$2,717	0.94 %

Time Deposits	**249,150**	**3,794**	**1.52 %**	249,543	4,997	2.00 %	269,075	6,394	2.38 %
Short-Term Borrowings	**11,030**	**28**	**0.26 %**	2,316	7	0.30 %	1,189	0	0 %
Long-Term Borrowings	**56,351**	**1,840**	**3.27 %**	68,356	2,523	3.69 %	80,735	3,401	4.21 %
Fed Funds Purchased	**0**	**0**	**0 %**	0	0	0 %	0	0	0 %
Securities Sold U/A to Repurchase	**19,458**	**90**	**0.46 %**	21,593	157	0.73 %	19,442	230	1.18 %
Total Interest Bearing Liabilities	**$625,388**	**$6,514**	**1.04 %**	$650,586	$9,405	1.45 %	$658,872	$12,742	1.93 %
Non-Interest Bearing Liabilities:									
Demand Deposits	**$80,087**			$71,661			$65,831		
Other Liabilities	**7,671**			13,292			13,337		
Stockholders' Equity	**99,834**			85,609			81,585		
Total Liabilities/Stockholders' Equity	**$812,980**			$821,148			$819,625		
Net Interest Income Tax Equivalent		**$31,082**			$29,897			$27,234	
Net Interest Spread			**3.99 %**			3.80 %			3.40 %
Net Interest Margin			**4.16 %**			3.99 %			3.63 %

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

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

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

NET INTEREST INCOME

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

Table 2 on the preceding page provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and interest expense as well as average tax equivalent rates earned and paid as of year-end 2012, 2011 and 2010.

The yield on earning assets was 5.03% in 2012, 5.25% in 2011, and 5.33% in 2010. The rate paid on interest bearing liabilities was 1.04% in 2012, 1.45% in 2011, and 1.93% in 2010. This resulted in an increase in our net interest spread to 3.99% in 2012, as compared to 3.80% in 2011 and 3.40% in 2010.

As Table 2 illustrates, the net interest margin, which is interest income less interest expense divided by average earning assets, was 4.16% in 2012 as compared to 3.99% in 2011 and 3.63% in 2010. The net interest margins are presented on a tax-equivalent basis. In 2012, yield on earning assets fell by 0.22%, from 5.25% to 5.03% while the rate paid on interest bearing liabilities dropped 0.41%. As the long end of the Treasury yield curve declined during 2012, asset yields fell. This was more than offset by lower costs on liabilities. Savings, NOW accounts and money market interest expense declined significantly as did the interest costs of certificates of deposit and long-term borrowings. The increase in spread and margin in 2012 as compared to 2011 and 2010 was similarly caused by falling rates. Interest income exempt from federal tax was $5,317,000 in 2012, $4,617,000 in 2011, and $3,771,000 in 2010. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34%.

The improvement in our net interest margin came from slightly lower earning asset yields and significantly lower funding costs in 2012 and 2011. Fully tax equivalent net interest income grew from 2011 to 2012 by $1,185,000 or 4.0% to $31,082,000. This occurred while the level of earning assets was effectively unchanged. Our improved net interest margin will be under pressure when interest rates start to rise since the Corporation continues to be liability sensitive. There will be more liabilities, including deposits, repricing than earning assets (loans and investments). To negate the potential impact of a lesser net interest margin, the Corporation will continue to focus on attracting lower cost checking, savings and money market accounts and reduce somewhat its dependence on higher priced certificates of deposit.

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

In 2012, the increase in net interest income on a fully tax equivalent basis of $1,185,000 resulted from an increase in volume of $1,589,000 and a decrease of $404,000 due to changes in rate. In 2011, the increase in net interest income of $2,663,000 resulted from an increase in volume of $2,270,000 and an increase of $393,000 due to changes in rate.

Table 3 — Changes in Income and Expense, 2012 and 2011

(Amounts in thousands)	2012 COMPARED TO 2011			2011 COMPARED TO 2010		
	VOLUME	RATE	NET	VOLUME	NET	RATE
Interest Income:						
Loans, Net	$635	$(1,271)	$(636)	$127	$(1,054)	$(927)
Taxable Investment Securities	(775)	(987)	(1,762)	407	(1,119)	(712)
Tax-Exempt Investment Securities	1,183	(488)	695	986	3	989
Other Short-Term Investments	(3)	0	(3)	(18)	(6)	(24)
Total Interest Income	$1,040	$(2,746)	$(1,706)	$1,502	$(2,176)	$(674)
Interest Expense:						
Savings, NOW and Money Markets	$(108)	$(851)	$(959)	$192	$(1,188)	$(996)
Time Deposits	(8)	(1,194)	(1,202)	(464)	(934)	(1,398)
Short-Term Borrowings	26	(5)	21	0	7	7
Long-Term Borrowings	(443)	(240)	(683)	(521)	(357)	(878)
Securities Sold U/A to Repurchase	(16)	(52)	(68)	25	(97)	(72)
Total Interest Expense	(549)	(2,342)	(2,891)	(768)	(2,569)	(3,337)
Net Interest Income	$1,589	$(404)	$1,185	$2,270	$393	$2,663

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

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2012, the provision for loan losses was $1,600,000 as compared to $1,900,000 as of December 31, 2011 and $2,575,000 as of December 31, 2010. The provision in 2012 decreased due to the Bank's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions and other relevant factors. Net charge-offs by the Corporation for the fiscal years ended December 31, 2012, 2011 and 2010, were $1,757,000, $1,672,000, and $2,196,000, respectively. See Allowance for Loan Losses on Page 30 for further discussion.

The Corporation did not change the methodology in which it determines charge-offs. Rather the challenges associated with the economy (higher unemployment and increased delinquencies) have been largely responsible for the increase in net charge-offs in 2012, 2011 and 2010 as compared to the prior years. While the Corporation cannot accurately predict future charge-offs, we anticipate the level of charge-offs may continue into 2013 if economic conditions continue to be unfavorable.

The allowance for loan losses as a percentage of average loans outstanding was 1.36% as of December 31, 2012, 1.44% as of December 31, 2011 and 1.39% as of December 31, 2010.

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

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

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

NON-INTEREST INCOME

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

Non-interest income through December 31, 2012 was $5,933,000, an increase of 33.9%, or $1,502,000, from 2011. Table 4 provides the major categories of non-interest income and each respective change comparing the last three years. The majority of the 2012 increase was due to an increase in gains on sales of mortgage loans and an increase in net gains on sales of investment securities. Two major contributors to the decline in 2011 were 1) non-recurring income of $800,000 in 2010 from the recovery on loss due to defalcation and 2) a sharp decline in new residential mortgage originations that were sold on the secondary market.

During 2012, the Corporation recorded a net gain of $813,000 from the sales of securities in its investment portfolio, an increase of $702,000 from 2011. The primary reasons for the increase in gains in 2012 were to shift a portion of the portfolio from taxable municipal bonds to tax free municipal bonds, and to sell some faster paying mortgage pools that were held at a premium. These strategies were responsible for a significant part of the net gain. These net gains were sufficient to offset losses on some zero-coupon municipal bonds sold during 2012. In 2011, gains totaled $111,000, while in 2010 they were $163,000. These gains resulted from the normal readjustment process within the portfolio.

The Corporation performs a quarterly impairment analysis. The analysis includes a review of investment securities owned by its subsidiary, First Keystone Community Bank, and a review of bank equity securities owned by the Corporation. With regards to the investment securities of the Bank, all individual investment securities held at the end of each quarter are evaluated. The evaluation determines if unrealized holding losses represent credit losses which could require an other-than-temporary impairment charge through earnings. Generally, unrealized losses related to general market conditions and/or resultant lack of liquidity in the market do not require impairment charges. Similarly, all bank equity securities held at each quarter end are evaluated for other-than-temporary impairment charges, primarily if the market value has declined significantly compared to the book value on an individual basis. Also, trends relating to overall credit quality of bank equity securities owned is considered in making an impairment charge decision.

Gains on sales of mortgage loans provided $1,016,000 in 2012 as compared to $368,000 in 2011 and $825,000 in 2010. The increase in gains on sales of mortgage loans in 2012 was due to two factors. First, the Bank originated $50,140,000 in residential mortgage loans and sold $30,732,000 in 2012. That compares favorably to 2011, when $23,795,000 were originated and $18,117,000 were sold. The second factor was the percentage gain on the mortgage loans sold increased from 2.04% in 2011 to 3.30% in 2012. The increase in volume was due to the continuing favorable interest rate for refinancing and the Bank’s emphasis on marketing its residential mortgage originations. The

increased percentage gains on sales of mortgage loans was achieved because of the continued drop in long-term interest rates during the period. During 2010, there was a significant wave of residential mortgage refinancing due to a drop in long-term interest rates. That led to a greater number of new residential mortgages sold on the secondary market. In 2011, that volume reduced and led to a $457,000 decline in gains on sales of mortgage loans. The Corporation continues to service the majority of mortgages which are sold. This servicing income provides an additional source of non-interest income on an ongoing basis.

Service charges and fees consisted primarily of service charges on deposit accounts and ATM fees and debit card income. Service charges and fees were lower by $41,000 in 2012 than in 2011, or 1.8%. Service charges on deposits declined due to lower fees collected on checking accounts and lower overdraft fees. While ATM and debit card fees rose, higher deferred costs related to underwriting of secondary market residential mortgages more than offset the increase. Service charges and fees decreased $70,000 in 2011 as compared to 2010, primarily due to a reduction in overdraft fees.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit investment products, and miscellaneous fees, increased $65,000 or 16.8% in 2012 and increased $117,000 or 43.3% in 2011. Other non-interest income rose in 2012 and 2011, which was caused in large measure by an increase in commissions earned on sales of retail non-deposit investment products. A recovery from the loss due to defalcation was received in 2010 in the amount of $800,000. This 2010 non-recurring income item made up 14.3% of non-interest income before investment securities gains (losses).

Table 4 — Non-Interest Income

(Amounts in thousands)		2012/2011 Increase/(Decrease)			2011/2010 Increase/(Decrease)		
	2012	Amount	%	2011	Amount	%	2010
Trust department	$746	$ 161	27.5	$585	$(56)	(8.7)	$641
Service charges and fees	2,182	(41)	(1.8)	2,223	(70)	(3.1)	2,293
Bank owned life insurance income	724	(33)	(4.4)	757	(9)	(1.2)	766
Gains on sales of mortgage loans	1,016	648	176.1	368	(457)	(55.4)	825
Other	452	65	16.8	387	117	43.3	270
Recovery on loss due to defalcation	0	0	**N/A**	0	(800)	N/A	800
Subtotal	5,120	800	18.5	4,320	(1,275)	(22.8)	5,595
Investment securities gains (losses) - net	813	702	632.4	111	(52)	(31.9)	163
Total	$5,933	$ 1,502	33.9	$4,431	$(1,327)	(23.0)	$5,758

NON-INTEREST EXPENSE

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

Total non-interest expense amounted to $20,398,000, an increase of $2,703,000, or 15.3% in 2012 compared to an increase of $423,000, or 2.5% in 2011. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to 51.0% of total non-interest expense in 2012 and 53.6% in 2011. Salaries and employee benefits increased $933,000, or 9.8% in 2012 and $431,000, or 4.8% in 2011. The majority of the increase was related to the hiring in 2012 of several new employees including a Residential Mortgage Consultant, a Training Director and a Business Deposit Specialist, among others. The balance of the increase was due to normal annual increases in salaries. In addition, the Corporation experienced a 21.8% increase in medical insurance for its employees, from $1,027,000 to $1,251,000. Salaries increased in 2011 due to normal, annual employee increases and in part to the new positions created from the opening of our Plymouth Office and the addition of an Information Security Officer. Health insurance increases added $40,000 to employee benefits in 2011. The number of full time equivalent employees was 193 as of December 31, 2012, and 190 as of December 31, 2011.

Net occupancy expense increased $41,000, or 3.0% in 2012 as compared to an increase of $64,000, or 4.9% in 2011. Furniture and equipment and computer expense increased $213,000, or 14.8% in 2012 compared to an increase of $73,000, or 5.4% in 2011. The increase was caused by higher service maintenance on equipment, including ATMs, higher depreciation, and a loss on disposal of leasehold improvements due to the relocation of our Kingston Office to a bank-owned facility. The increases in occupancy and furniture expenses in 2011 relate to higher maintenance and

repairs for buildings and software, as well as higher real estate taxes. FDIC insurance expense decreased $148,000, or 23.3% in 2012 as compared to a decrease of $242,000, or 27.6% in 2011. FHLB prepayment penalties of $811,000 were one-time expenses related to the early prepayment of borrowings with the Federal Home Loan Bank (“FHLB”). Other non-interest expense, including state shares tax, ATM and debit card fees and professional services, increased by 17.8% or $853,000 in 2012 after increasing by $97,000 or 2.1% in 2011. This increase in 2012 is primarily related to legal, collections and expenses associated with foreclosed assets held for resale and an increase in ATM and debit card fees.

The overall level of non-interest expense remains low, relative to the Bank’s peers (community banks from $500 million to $1 billion in assets). In fact, the Bank’s total non-interest expense was 2.51% and 2.15% of average assets in 2012 and 2011, respectively. The Bank’s non-interest expense as a percentage of average assets places the Bank among the leaders in its peer financial institution categories in controlling non-interest expense.

Table 5 — Non-Interest Expense

(Amounts in thousands)	**2012/2011**				2011/2010		
	Increase/(Decrease)				Increase/(Decrease)		
	2012	Amount	%	2011	Amount	%	2010
Salaries and employee benefits	$10,413	$933	9.8	$9,480	$431	4.8	$9,049
Occupancy, net	1,405	41	3.0	1,364	64	4.9	1,300
Furniture and equipment and computer expense	1,649	213	14.8	1,436	73	5.4	1,363
FDIC Insurance	486	(148)	(23.3)	634	(242)	(27.6)	876
FHLB prepayment penalties	811	811	**N/A**	0	0	N/A	0
Other	5,634	853	17.8	4,781	97	2.1	4,684
Total	$20,398	$2,703	15.3	$17,695	$423	2.5	$17,272

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2012, was $2,187,000 as compared to $2,552,000 and $2,362,000 for the years ended December 31, 2011 and 2010, respectively. The effective income tax rate was 17.7% in 2012, 20.5% in 2011, and 20.9% in 2010. The decrease in the effective tax rate for 2012 was due to additional tax exempt income received and an additional low-income housing tax credit recognized during the period. The tax rate in 2011 was just slightly lower than 2010. The Corporation looks to maximize its tax-exempt income derived from both tax-free loans and tax-free municipal securities without triggering the alternative minimum tax.

FINANCIAL CONDITION

GENERAL

Total assets increased to $819,966,000 at year-end 2012, an increase of 0.2% from year-end 2011. As of December 31, 2012, total deposits amounted to $608,834,000, a decrease of 2.5% from 2011. Total assets as of December 31, 2011 were $818,546,000, an increase of 2.8% over 2010, while total deposits as of year-end 2011 amounted to $624,349,000, a decrease of 0.4% from 2010.

Net loans increased in 2012 from $410,066,000 to $427,124,000, a 4.2% increase. Loan demand continues to be weak as borrowers, both consumer and business, are reducing their leverage positions. Loans in 2011 grew only slightly from 2010 by $6,116,000 or 1.5%.

The decreases in investments and long-term borrowings were attributable to a program in which investments were sold to pay-off several long-term borrowings to further improve net interest margin.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Borrowings increased in 2012 by $4,368,000 and increased in 2011 by $7,844,000. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals, continues to be the Corporation's most significant source of funds.

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 92.0% for 2012, compared to 91.2% for 2011 and 91.5% for 2010. 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.

LOANS

Total loans, net of unearned income, increased to $432,896,000 as of December 31, 2012, as compared to a balance of $415,995,000 as of December 31, 2011. Table 6 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans, net of unearned income, increased $16,901,000, or 4.1% in 2012 compared to an increase of $6,344,000, or 1.6% in 2011.

The lackluster economy and resultant decline in loan demand accounted for nominal growth in the loan portfolio in 2012. Residential Real Estate loans increased $16,293,000 to $147,011,000 as of December 31, 2012, as compared to $130,718,000 as of December 31, 2011. The increase was the result of new originations and, to a lesser extent, refinances held in the Bank's portfolio. The Corporation continued 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 Commercial Secured by Real Estate loan portfolio decreased $15,307,000 to $221,338,000 as of December 31, 2012 as compared to $236,645,000 at December 31, 2011. The decrease was the result of weak new loan originations; a $6,405,000 pay-off of one large commercial mortgage; pay-offs of eight commercial mortgages with balances of $450,000 or more; and the impact of typical portfolio run-off. The Commercial - Other portfolio increased $7,266,000 to $28,714,000 as of December 31, 2012, as compared to $21,448,000 as of December 31, 2011. This increase was primarily due to three large new loan originations, including a $4,500,000 term loan and a $2,000,000 line of credit to one borrower and another $1,688,000 term loan to an additional borrower. Other increases in the loan portfolio in 2012 were attributed to the $9,413,000 increase in the Tax Exempt portfolio to $29,192,000 at December 31, 2012 from $19,779,000 at December 31, 2011. This increase was mainly due to four new unrelated loan originations totaling $9,138,000.

Management believes that the loan portfolio is well diversified. The total commercial portfolio was $279,244,000 of which $225,173,000 or 52.0% of gross loans is secured by commercial real estate.

The largest relationship is a manufacturing/fabrication company and its related entities. The company has a long history of successful operations dating back to 1980. The relationship had outstanding loan balances and unused commitments of $9,475,000 at December 31, 2012. The debt consists of approximately $6,980,000 in term debt secured by various real estate holdings, and approximately $2,495,000 in operating lines of credit secured by business assets and guaranties.

The second largest relationship is an $8,387,000 tax free loan to a municipality founded in 1816 consisting of 35 square miles. According to township officials, the population has been increasing steadily since 2001 and is currently in excess of 11,000 people. In 2012, the township completed its $74,000,000 sewer expansion project. The Bank's loan is secured by project receivables and the full faith, credit, and taxing power of the township.

The third largest relationship is a real estate development company and its related entities, specializing in the design, construction, and management of multi-tenant residential housing. The company was established in the late 1980s. The relationship had outstanding loan balances of $8,348,000 at December 31, 2012, and is secured primarily by income producing multi-tenant real estate.

The fourth largest relationship consisted of the net balance of $8,331,000 after participation shares sold of $3,040,000. This relationship is comprised of several first lien mortgages relating to office and professional rental properties and a $5,000,000 line of credit to a planned residential community. The principal and related companies have been involved in real estate development since 1974, and have successfully developed residential communities, medical office facilities, and professional office facilities. The entire relationship is secured by a combination of real estate and marketable securities.

The fifth largest relationship is a real estate holding company established in 2006 and its related entities. The company was formed to construct and manage a multi-tenant medical complex, housing offices of medical practitioners, social services providers, and other related services. The relationship had outstanding loan balances of $7,232,000 as of December 31, 2012. The loans are secured primarily by income producing commercial real estate and perfected by security interest in business assets.

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

Each of the aforementioned loans are paying as agreed and none of the loans are considered criticized or classified. The property securing each of the loans was appraised at the time the loan was originated. Appraisals are ordered independently of the loan approval process from appraisers on an approved list. All appraisals are reviewed internally for conformity with accepted standards of the Bank.

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

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as $424,244,000 or 98.0% of gross loans are graded Pass; $2,884,000 or 0.7% are graded Special Mention; $5,600,000 or 1.3% are graded Substandard; and $0 are graded Doubtful. The rating is intended to represent the best assessment of risk available at a given point in time, based upon a review of the borrower's financial statements, credit analysis, payment history with the Bank, credit history and lender knowledge of the borrower. See Note 4 — Loans for risk grading tables.

Commercial & Industrial non-pass grades decreased to $916,000 as of December 31, 2012, as compared to $1,436,000 as of December 31, 2011. Commercial Real Estate non-pass grades decreased to $6,241,000 as of December 31, 2012, as compared to $10,375,000 as of December 31, 2011. The $4,134,000 decrease in Commercial Real Estate was the result of $1,052,000 in loans upgraded, $1,077,000 in loans charged-down, and $1,094,000 in loans transferred into foreclosed assets held for resale, with the balance attributed to borrower repayments including one large payoff of $431,000. The Residential Real Estate and Consumer Loans non-pass grades increased to $1,327,000 as of December 31, 2012, compared to $1,115,000 as of December 31, 2011. The increase was due to the net effect of down-grading several residential assets and the transfer of one large residential property to foreclosed assets held for resale.

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

Table 6 — Loans Outstanding, Net of Unearned Income

(Amounts in thousands)	December 31,				
	2012	2011	2010	2009	2008
Commercial, financial and agricultural:					
Commercial secured by real estate	$221,338	$236,645	$227,147	$203,413	$206,095
Commercial - other	28,714	21,448	29,693	42,815	33,104
Tax exempt - real estate and other	29,192	19,779	12,450	12,525	18,920
Real estate (primarily residential mortgage loans)	147,011	130,718	131,981	138,092	136,288
Consumer loans	6,473	7,429	8,781	10,802	15,291
Total Gross Loans	432,728	416,019	410,052	407,647	409,698
Add (deduct): Unearned income and unamortized loan fees net of costs	168	(24)	(401)	(950)	(1,331)
Total Loans, net of unearned income	$432,896	$415,995	$409,651	$406,697	$408,367

INVESTMENT SECURITIES

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

The investment portfolio has been allocated between securities available-for-sale, including restricted equity securities, and securities held-to-maturity. No investment securities were established in a trading account. Available-for-sale securities decreased $32,818,000 or 9.8% to $301,195,000 in 2012 as nearly all classes of securities declined. The primary reason for the decline was normal principal payments and maturities in the investment portfolio. Available-for-sale securities increased $23,748,000, or 7.7% to $334,013,000 in 2011. At December 31, 2012, the net unrealized gain, net of the tax effect, on these securities was $12,528,000 and was included in stockholders' equity as accumulated other comprehensive income. At December 31, 2011, accumulated other comprehensive income, net of tax effect, amounted to $7,757,000. In 2012, held-to-maturity securities decreased $44,000, or 1.7% to $2,561,000 after decreasing $3,661,000, or 58.4% in 2011. Table 7 provides data on the carrying value of the Corporation's investment portfolio on the dates indicated. The vast majority of investment security purchases are allocated as available-for-sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate an investment security.

The investment portfolio includes U.S. Government corporations and agencies, corporate obligations, mortgage-backed securities, and obligations of state and political subdivisions, both tax-exempt and taxable. In addition, the investment portfolio includes restricted equity securities consisting primarily of common stock investments in the Federal Home Loan Bank as of December 31, 2012. Marketable equity securities consists of common stock investments in other commercial banks and bank holding companies. A quarterly impairment analysis is conducted as outlined under non-interest income on page 25 of Management's Discussion and Analysis.

Securities available for sale may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on the Corporation's consolidated statements of income. As of December 31, 2012, the investment portfolio does not contain any off-balance sheet derivatives or trust preferred investments.

During 2012, interest-bearing deposits in other banks increased to $10,882,000 from $1,776,000 in 2011. In 2012, the increase in interest-bearing deposits in other banks was the result of an excess cash position on December 31, 2012. In 2011, the decrease in interest-bearing deposits in other banks, from $4,559,000 in 2010 to $1,776,000, was the result of more efficient investment of excess funds into the investment portfolio.

Table 7 — Carrying Value of Investment Securities

(Amounts in thousands)	December 31,					
	2012		2011		2010	
	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity
U. S. Government corporations and agencies	$72,875	$ 2,094	$81,056	$ 2,138	$51,873	$ 5,169
Obligations of state and political subdivisions	176,953	467	186,785	467	177,252	1,097
Corporate securities	44,507	0	59,242	0	72,952	0
Marketable equity securities	1,977	0	1,741	0	1,825	0
Restricted equity securities	4,883	0	5,189	0	6,363	0
Total	$301,195	$ 2,561	$334,013	$ 2,605	$310,265	$ 6,266

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2012, the allowance for loan losses was $5,772,000 as compared to $5,929,000 as of December 31, 2011. 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 the various control processes,

including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

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

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

Table 8 contains an analysis of the allowance for loan losses indicating charge-offs and recoveries by the year. In 2012, net charge-offs as a percentage of average loans were 0.4%. In 2011, net charge-offs as a percentage of average loans were 0.4%, compared to 0.5% in 2010. Net charge-offs amounted to $1,757,000 in 2012, $1,672,000 in 2011, and $2,196,000 in 2010. The increase in net charge-offs in 2012 relates primarily to increased losses on commercial loans secured by real estate. These relationships include a $586,000 charge down of a commercial relationship located outside our market area, which represents 33.4% of net charge-offs; a charge down of $329,000 on an income producing commercial relationship, which represents 18.7% of net charge-offs; and a charge down of $159,000 on a commercial real estate relationship, which represents 9.1% of net charge-offs in 2012. The remainder of charge-offs were comprised of smaller residential, commercial real estate and consumer relationships. The decrease in net charge-offs in 2011 as compared to 2010 related primarily to decreased losses in commercial loans secured by real estate. The increase in net charge-offs in 2010 as compared to prior years relate primarily to increased losses on commercial loans and real estate loans.

For the year ended December 31, 2012, the provision for loan losses was $1,600,000 as compared to $1,900,000 for 2011 and $2,575,000 for 2010. The provision, net of charge-offs and recoveries, decreased the year-end Allowance for Loan Losses to $5,772,000 of which 9.9% was attributed to the Commercial-other component; 49.2% attributed to Commercial Real Estate component; 1.4% attributed to the Consumer component; 26.4% attributed to Real estate (primarily residential mortgage loans) component and 13.1% being the unallocated component (refer to the activity in the allowance for loan losses table in Note 4 — Loans on page 60). The Corporation determined that the provision for loan losses made during 2012 was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of December 31, 2012.

Table 8 — Analysis of Allowance for Loan Losses

(Amounts in thousands)	Years Ended December 31,				
	2012	2011	2010	2009	2008
Balance at beginning of period	$5,929	$5,701	$5,322	$5,195	$5,046
Charge-offs:					
Commercial, financial and agricultural	264	485	389	211	44
Real estate	1,481	1,186	1,778	354	633
Consumer	87	98	95	169	62
	1,832	1,769	2,262	734	739
Recoveries:					
Commercial, financial and agricultural	23	28	39	13	154
Real estate	23	53	13	25	6
Consumer	29	16	14	23	28
	75	97	66	61	188
Net charge-offs	1,757	1,672	2,196	673	551
Additions charged to operations	1,600	1,900	2,575	800	700
Balance at end of period	$5,772	$5,929	$5,701	$5,322	$5,195
Ratio of net charge-offs during the period to average loans outstanding during the period	0.4 %	0.4 %	0.5 %	0.2 %	0.1 %
Allowance for loan losses to average loans outstanding during the period	1.36 %	1.44 %	1.39 %	1.30 %	1.33 %

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 1.36% in 2012, 1.44% in 2011 and 1.39% in 2010.

Table 9 sets forth the allocation of the Bank's allowance for loan losses by loan category and the percentage of loans in each category to total loans receivable at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

Table 9 — Allocation of Allowance for Loan Losses

(Amounts in thousands)	December 31,									
	2012	%*	2011	%*	2010	%*	2009	%*	2008	%*
Commercial, financial and agricultural	$573	11.4	$489	9.1	$565	11.4	$970	19.3	$721	15.8
Real estate – mortgage	4,361	87.0	4,735	88.3	4,270	86.1	3,948	78.7	3,641	79.7
Consumer and other loans	80	1.6	137	2.6	123	2.5	99	2.0	207	4.5
Unallocated	758	**N/A**	568	N/A	743	N/A	305	N/A	626	N/A
	$5,772	100.0	$5,929	100.0	$5,701	100.0	$5,322	100.0	$5,195	100.0

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

NON-PERFORMING ASSETS

Table 10 details the Corporation’s non-performing assets 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 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 we would not otherwise consider. Modifications to loans classified as a TDR generally include reductions in contractual interest rates, principal deferment 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 decreased to $3,783,000 in 2012 as compared to $4,968,000 and $5,425,000 in 2011 and 2010, respectively. The economy, in particular, high unemployment, weak job markets, unsettled fuel prices, rising 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 and rents and property values in some markets have fallen. Losses on commercial real estate, which increased in 2012, are projected to continue at higher than average levels through early 2013. Impaired loans decreased to $2,363,000 in 2012, from $4,188,000 in 2011 and $4,276,000 in 2010. Foreclosed assets held for resale decreased to $468,000 in 2012 from $780,000 in 2011 and $1,149,000 in 2010. Loans past-due 90 days or more and still accruing interest increased to $952,000 in 2012 from $0 in 2011 and 2010. These loans are deemed to be well secured and in the process of collection. They consist of two

related commercial real estate loans that are well secured by real estate, which have an occupancy rate of 100%. Non-performing assets to period end loans and foreclosed assets was 0.9% in 2012, 1.2% in 2011 and 1.3% in 2010. Total non-performing assets to total assets was 0.5% in 2012, 0.6% in 2011 and 0.7% in 2010. The allowance for loan losses to total non-performing assets was 152.6% in 2012, 119.3% in 2011 and 105.1% in 2010. Additional detail can be found on page 33, Table 10 — Non-Performing Assets and page 65 in the Financing receivables 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.

Impaired Loans were $2,363,000 at December 31, 2012. The largest relationship is represented by five loans carrying a balance of $707,000, secured by commercial real estate. The year-end valuation carried a net realizable value of $707,000, after an estimated average cost to sell of 14%, resulting in a specific allocation of $0. The second largest relationship is represented by two loans carrying a balance of $240,000 secured by commercial real estate. The year-end valuation carried a net realizable value of $358,000, after an estimated 10% cost to sell, resulting in a specific allocation of $0. The third largest relationship is represented by one loan carrying a balance of $226,000 secured by residential real estate. The year-end valuation carried a net realizable value of $226,000, after an estimated cost to sell of 10%, resulting in a specific allocation of $0. The estimated cost to sell percentage is determined based upon the market area in which the real estate securing the loan is located and therefore can differ from one loan to another. Of the $2,363,000 impaired loans, none are located outside our primary market area. None of the impaired loans are participated facilities.

The Corporation'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 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, and we actively work with borrowers to resolve credit problems and will continue our close monitoring efforts in 2013. As of December 31, 2012, the Corporation did not have any significant loan modifications classified as troubled debt restructurings in its loan portfolio. Excluding the assets disclosed in the Non-Performing Assets Table in Table 10, 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 non-performing loans and 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.

Interest income received on non-performing loans in 2012, 2011 and 2010 was $34,000, $54,000 and $63,000, respectively. Interest income, which would have been recorded on these loans under the original terms in 2012, 2011 and 2010 was $279,000, $342,000 and $316,000, respectively. At December 31, 2012 and 2011, the Corporation had no outstanding commitments to advance additional funds with respect to these non-performing loans.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2012 and 2011, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 10 — Non-Performing Assets

(Amounts in thousands)

	2012	2011	2010
Non-performing assets			
Impaired loans	$2,363	$4,188	$4,276
Foreclosed assets held for resale	468	780	1,149
Loans past-due 90 days or more and still accruing interest	952	0	0
Total non-performing assets	$3,783	$4,968	$5,425
Impaired loans			
Non-performing loans	$2,363	$4,188	$4,276
Allocated allowance for loan losses	(223)	(947)	(605)
Net investment in impaired loans	$2,140	$3,241	$3,671
Impaired loans with a valuation allowance	$463	$2,556	$2,553
Impaired loans without a valuation allowance	1,900	1,632	1,723
Total impaired loans	$2,363	$4,188	$4,276
Valuation allowance related to impaired loans	$223	$947	$605
Valuation allowance as a percent of impaired loans	9.4 %	22.6 %	14.2 %
Impaired loans to loans net of unearned discount	0.6 %	1.0 %	1.0 %
Non-performing assets to period-end loans and foreclosed assets	0.9 %	1.2 %	1.3 %
Total non-performing assets to total assets	0.5 %	0.6 %	0.7 %
Allowance for loan losses to impaired loans	244.3%	141.6%	133.3%
Allowance for loan losses to total non-performing assets	152.6%	119.3%	105.1%

Real estate mortgages comprise 86.0% of the loan portfolio as of December 31, 2012, as compared to 88.7% in 2011. 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 fixed rate mortgages. The real estate loans are concentrated primarily in our market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately each three to five years and are also concentrated in our market area. The Corporation's loss exposure on its non-performing 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 sixteen full service office locations. The Bank offers a broad selection of deposit products and continually evaluates its interest rates and fees on deposit products. The Bank regularly reviews competing financial institutions interest rates, especially when establishing interest rates on certificates of deposit.

Deposits decreased by $15,515,000, or 2.5% for the year ending December 31, 2012. This decrease compares unfavorably to a deposit decrease of $2,546,000, or 0.4% in 2011. In 2012, the Bank experienced a $929,000 or 1.2% increase in non-interest bearing deposits. However, the overall drop in deposits in 2012 of $15,515,000 was due in large part to the loss of one significant depositor. The overall drop in deposits in 2011 of $2,546,000 was due to lower volume of new retail certificates of deposit less than $100,000.

Total borrowings were $99,589,000 as of December 31, 2012, compared to $95,221,000 on December 31, 2011. During 2012, long-term borrowings decreased from $64,339,000 to $44,520,000. The decrease in long-term borrowings resulted primarily from a program in which investments were sold at a gain and long-term debt was repaid with a penalty. The purpose of the program was to increase net interest income, improve leverage ratios and decrease sensitivity to rising interest rates. Additionally, long-term borrowings decreased due to maturation and repayment of individual term notes with FHLB. Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more. In connection with FHLB borrowings, U.S. Treasury tax and loan notes, Federal Discount Window, and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

Short-term borrowings were used to offset repayments of maturing long-term debt. Short-term debt increased from $30,882,000 in 2011 to $55,069,000. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window, U.S. Treasury tax and loan notes, and short-term borrowings from FHLB. Short-term borrowings from FHLB are commonly used to offset seasonal fluctuations in

deposits.

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains or losses on investment securities available-for-sale, net of taxes, referred to as accumulated other comprehensive income (loss), may increase or decrease total equity capital. The total net increase in capital was $10,238,000 in 2012 after an increase of $14,032,000 in 2011. Approximately 46.6% of the increase in equity capital in 2012 related to an increase in accumulated other comprehensive income due to market fluctuations, while approximately 66.9% of the increase in equity capital in 2011 related to an increase in accumulated other comprehensive income. The accumulated other comprehensive income amounted to $12,528,000 in 2012 and $7,757,000 in 2011.

The Corporation had 237,183 shares of common stock as of December 31, 2012, and 242,517 shares of common stock as of December 31, 2011, at a cost of $5,890,000 and $6,069,000, respectively, as treasury stock. Beginning in June 2012, the Corporation began issuing treasury stock for new shares purchased by participants in the Corporation's Dividend Reinvestment Program ("DRIP"). Prior to that, shares needed to fill purchase orders through the DRIP were acquired on the open market. This change was made to reduce the volatility in stock price, which occurred because of large quarterly purchases and to augment capital formation.

Return on average equity ("ROE") is computed by dividing net income by average stockholders' equity. This ratio was 10.19% for 2012, 11.57% for 2011, and 10.98% for 2010. Refer to Performance Ratios on page 20 — Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 11 reflects risk-based capital ratios and the leverage ratio for the Corporation and Bank. The Corporation's leverage ratio was 8.97% at December 31, 2012 and 8.07% at December 31, 2011.

The Corporation has consistently maintained regulatory capital ratios at or above the "well capitalized" standards. For additional information on capital ratios, see Note 16 — Regulatory Matters on page 73. As Table 11 indicates, the risk-based capital ratios for both the Corporation and the Bank increased over the prior year. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments.

Table 11 — Capital Ratios

	December 31, 2012		December 31, 2011	
	Corporation	Bank	Corporation	Bank
Risk-Based Capital:				
Tier I risk-based capital ratio	13.33 %	13.71 %	11.99 %	12.57 %
Total risk-based capital ratio (Tier 1 and Tier 2)	14.46 %	14.78 %	13.09 %	13.64 %
Leverage Ratio:				
Tier I capital to average assets	8.97 %	9.25 %	8.07 %	8.59 %

LIQUIDITY MANAGEMENT

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

Liquidity is needed to provide the funding requirements of depositor's withdrawals, loan growth, and other operational needs. Asset liquidity is provided by investment securities maturing in one year or less, other short-term investments, federal funds sold, and cash and due from banks. At year-end 2012, cash and due from banks increased to $10,038,000 from $8,403,000. The liquidity is augmented by repayment of loans and cash flows from the mortgage backed securities.

Liability liquidity is accomplished by maintaining a core deposit base, acquired by attracting new deposits and retaining maturing deposits. Also, short-term borrowings provide funds to meet liquidity needs.

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

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

Table 12 represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of December 31, 2012 and 2011.

Table 12 — Contractual Obligations

(Amounts in thousands)

December 31, 2012	Less than 1 Year	1 - 3 Years	3 -5 Years	Over 5 Years	Total
Time deposits	$144,283	$73,785	$29,695	$0	$247,763
Securities sold under agreement to repurchase	17,059	0	0	0	17,059
FHLB borrowings	45,010	12,000	5,000	20,000	82,010
Commitments to grant loans[1]	11,242	0	0	0	11,242
Commitments to fund loans for secondary market mortgages[1]	2,828	0	0	0	2,828
Unfunded commitments on lines of credit[1]	49,583	0	0	0	49,583
Financial standby letters of credit[1]	720	0	0	0	720
Performance standby letters of credit[1]	3,714	0	0	0	3,714
Purchase and building commitments	840	0	0	0	840
Operating lease obligations	142	186	112	2,766	3,206
Capital lease obligations	132	264	240	0	636
	$275,553	$86,235	$35,047	$22,766	$419,601

[1]The Corporation does not expect all of the commitments and letters of credit to be fully funded. The total commitments amount related to these contractual obligations does not necessarily represent future cash requirements.

(Amounts in thousands)

December 31, 2011	Less than 1 Year	1 - 3 Years	3 -5 Years	Over 5 Years	Total
Time deposits	$135,711	$90,269	$26,151	$0	$252,131
Securities sold under agreement to repurchase	18,132	0	0	0	18,132
FHLB borrowings	28,750	32,750	13,000	2,000	76,500
Commitments to grant loans[1]	5,703	0	0	0	5,703
Commitments to fund loans for secondary market mortgages[1]	1,311	0	0	0	1,311