FIRST KEYSTONE CORP
Form 10-Q
August 07, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

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

For the quarterly period ended June 30, 2015

or

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

For the transition period from ________ to ________

Commission File Number: 2-88927

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

**Pennsylvania** **23-2249083**

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically 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 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

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

Common Stock, $2 Par Value, 5,593,538 shares as of August 3, 2015

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Unaudited)

| *(Dollars in thousands, except per share data)* | June 30, 2015 | December 31, 2014 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $7,389 | $ 7,543 |
| Interest-bearing deposits in other banks | 331 | 424 |
| Total cash and cash equivalents | 7,720 | 7,967 |
| Time deposits with other banks | 1,482 | 1,482 |
| Investment securities available-for-sale | 355,046 | 347,666 |
| Investment securities held-to-maturity (fair value 2015- $34; 2014 - $1,060) | 33 | 1,056 |
| Restricted investment in bank stocks | 6,245 | 5,308 |
| Loans | 502,172 | 487,461 |
| Allowance for loan losses | (6,600) | (6,390) |
| Net loans | 495,572 | 481,071 |
| Premises and equipment, net | 20,342 | 20,871 |
| Accrued interest receivable | 4,005 | 3,313 |
| Cash surrender value of bank owned life insurance | 21,565 | 21,236 |
| Investments in low-income housing partnerships | 1,046 | 1,130 |
| Goodwill | 19,133 | 19,133 |
| Core deposit intangible, net | | 122 |
| Foreclosed assets held for resale | 248 | 55 |
| Deferred income taxes | 1,048 | |
| Other assets | 3,181 | 1,943 |
| TOTAL ASSETS | $936,666 | $ 912,353 |
| | | |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing | $99,407 | $ 96,530 |
| Interest bearing | 566,694 | 565,032 |
| Total deposits | 666,101 | 661,562 |
| Short-term borrowings | 88,462 | 73,123 |
| Long-term borrowings | 70,286 | 65,339 |

| | | |
|---|---|---|
| Accrued interest payable | 430 | 399 |
| Deferred income taxes | | 211 |
| Other liabilities | 5,233 | 5,448 |
| TOTAL LIABILITIES | 830,512 | 806,082 |
| | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, par value $2.00 per share; authorized 1,000,000 shares in 2015 and 2014; issued 0 in 2015 and 2014 | | |
| Common stock, par value $2.00 per share; authorized 20,000,000 shares in 2015 and 2014; issued 5,826,912 in 2015 and 5,802,521 in 2014; outstanding 5,593,538 in 2015 and 5,567,372 in 2014 | 11,654 | 11,605 |
| Surplus | 33,225 | 32,674 |
| Retained earnings | 65,353 | 63,485 |
| Accumulated other comprehensive income | 1,687 | 4,330 |
| Treasury stock, at cost, 233,374 shares in 2015 and 235,149 in 2014 | (5,765) | (5,823) |
| TOTAL STOCKHOLDERS' EQUITY | 106,154 | 106,271 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $936,666 | $ 912,353 |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2015 AND 2014

(Unaudited)

| *(Dollars in thousands, except per share data)* | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | $ 5,372 | $ 5,065 | $ 10,692 | $ 10,026 |
| Interest and dividend income on investment securities: | | | | |
| Taxable | 1,657 | 2,005 | 3,348 | 4,008 |
| Tax-exempt | 733 | 607 | 1,404 | 1,240 |
| Dividends | 15 | 16 | 30 | 32 |
| Dividend income on restricted investment in bank stocks | 72 | 83 | 276 | 102 |
| Interest on interest bearing deposits in other banks | 8 | | 16 | 1 |
| Total interest income | 7,857 | 7,776 | 15,766 | 15,409 |
| | | | | |
| INTEREST EXPENSE | | | | |
| Interest on deposits | 776 | 743 | 1,528 | 1,557 |
| Interest on short-term borrowings | 66 | 53 | 130 | 88 |
| Interest on long-term borrowings | 387 | 312 | 763 | 588 |
| Total interest expense | 1,229 | 1,108 | 2,421 | 2,233 |
| | | | | |
| Net interest income | 6,628 | 6,668 | 13,345 | 13,176 |
| Provision for loan losses | 213 | 200 | 425 | 333 |
| Net interest income after provision for loan losses | 6,415 | 6,468 | 12,920 | 12,843 |
| | | | | |
| NON-INTEREST INCOME | | | | |
| Trust department | 240 | 269 | 454 | 495 |
| Service charges and fees | 423 | 394 | 822 | 711 |
| Bank owned life insurance income | 165 | 167 | 329 | 349 |
| ATM fees and debit card income | 310 | 289 | 593 | 549 |
| Gains on sales of mortgage loans | 133 | 56 | 314 | 80 |
| Net investment securities gains | 603 | 1,203 | 1,095 | 1,800 |
| Impairment charges on equity securities | (14) | | (14) | |
| Other | 133 | 140 | 257 | 249 |
| Total non-interest income | 1,993 | 2,518 | 3,850 | 4,233 |
| | | | | |
| NON-INTEREST EXPENSE | | | | |
| Salaries and employee benefits | 2,847 | 2,825 | 5,691 | 5,642 |
| Occupancy, net | 406 | 439 | 874 | 895 |
| Furniture and equipment | 144 | 153 | 291 | 307 |

| | | | | |
|---|---|---|---|---|
| Computer expense | 149 | 280 | 383 | 543 |
| Professional services | 158 | 134 | 312 | 297 |
| Pennsylvania shares tax | 190 | 158 | 366 | 317 |
| FDIC insurance | 129 | 119 | 253 | 237 |
| ATM and debit card fees | 172 | 175 | 297 | 291 |
| Data processing fees | 180 | 158 | 341 | 196 |
| Foreclosed assets held for resale expense | 42 | 19 | 49 | 122 |
| Advertising | 107 | 183 | 180 | 308 |
| Other | 872 | 796 | 1,642 | 1,536 |
| Total non-interest expense | 5,396 | 5,439 | 10,679 | 10,691 |
| | | | | |
| Income before income tax expense | 3,012 | 3,547 | 6,091 | 6,385 |
| Income tax expense | 582 | 791 | 1,212 | 1,331 |
| NET INCOME | $ 2,430 | $ 2,756 | $4,879 | $5,054 |
| | | | | |
| PER SHARE DATA | | | | |
| Net income per share: | | | | |
| Basic | $ 0.44 | $ 0.50 | $0.88 | $0.91 |
| Diluted | 0.44 | 0.50 | 0.88 | 0.91 |
| Dividends per share | 0.27 | 0.26 | 0.54 | 0.52 |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| *(Dollars in thousands)* | Three Months Ended June 30, 2015 | 2014 |
|---|---|---|
| Net Income | $ 2,430 | $ 2,756 |
| Other comprehensive (loss) income: | | |
| Unrealized net holding (losses) gains on available-for-sale investment securities arising during the period, net of income taxes of $(1,721) and $1,244, respectively | (3,331 ) | 2,417 |
| Less reclassification adjustment for net gains included in net income, net of income taxes of $(205) and $(409), respectively (a) (c) | (398 ) | (794 ) |
| Less reclassification adjustment for impairment charge on equity securities included in net income, net of income taxes of $5 and $0, respectively (b) (c) | 9 | |
| Total other comprehensive (loss) income | (3,720 ) | 1,623 |
| Total Comprehensive (Loss) Income | $ (1,290 ) | $ 4,379 |

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

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

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

| *(Dollars in thousands)* | Six Months Ended June 30, 2015 | 2014 |
|---|---|---|
| Net Income | $ 4,879 | $ 5,054 |
| Other comprehensive (loss) income: | | |

| | | |
|---|---|---|
| Unrealized net holding (losses) gains on available-for-sale investment securities arising during the period, net of income taxes of $(1,005) and $2,638, respectively | (1,929 ) | 5,125 |
| Less reclassification adjustment for net gains included in net income, net of income taxes of $(372) and $(612), respectively (a) (c) | (723 ) | (1,188 ) |
| Less reclassification adjustment for impairment charge on equity securities included in net income, net of income taxes of $5 and $0, respectively (b) (c) | 9 | |
| Total other comprehensive (loss) income | (2,643 ) | 3,937 |
| Total Comprehensive Income | $ 2,236 | $ 8,991 |

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

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

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

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

SIX MONTHS ENDED JUNE 30, 2015 AND 2014

(Unaudited)

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

| | Common Stock | | Surplus | Retained | Accumulated Other Comprehensive | Treasury | Total Stockholders' |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | | Earnings | Income (Loss) | Stock | Equity |
| Balance at January 1, 2015 | 5,802,521 | $11,605 | $32,674 | $63,485 | $4,330 | $(5,823) | $106,271 |
| Net Income | | | | 4,879 | | | 4,879 |
| Other comprehensive loss, net of taxes | | | | | (2,643) | | (2,643) |
| Issuance of common stock under dividend reinvestment plan and exercise of employee stock options | 24,391 | 49 | 551 | | | 58 | 658 |
| Dividends - $0.54 per share | | | | (3,011) | | | (3,011) |
| Balance at June 30, 2015 | 5,826,912 | $11,654 | $33,225 | $65,353 | $1,687 | $(5,765) | $106,154 |
| | | | | | | | |
| Balance at January 1, 2014 | 5,756,474 | $11,513 | $31,626 | $59,089 | $(54) | $(5,823) | $96,351 |
| Net Income | | | | 5,054 | | | 5,054 |
| Other comprehensive income, net of taxes | | | | | 3,937 | | 3,937 |
| Issuance of common stock under dividend reinvestment plan | 22,161 | 44 | 515 | | | | 559 |
| Dividends - $0.52 per share | | | | (2,874) | | | (2,874) |
| Balance at June 30, 2014 | 5,778,635 | $11,557 | $32,141 | $61,269 | $3,883 | $(5,823) | $103,027 |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30, 2015 AND 2014

(Unaudited)

*(Dollars in thousands)*

| | 2015 | 2014 |
|---|---|---|
| OPERATING ACTIVITIES | | |
| Net income | $4,879 | $5,054 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 425 | 333 |
| Depreciation and amortization | 784 | 804 |
| Net premium amortization on investment securities | 1,324 | 843 |
| Deferred income tax expense (benefit) | 113 | (32) |
| Gains on sales of mortgage loans | (314) | (80) |
| Proceeds from sales of mortgage loans originated for resale | 11,079 | 3,298 |
| Originations of mortgage loans originated for resale | (8,853) | (4,173) |
| Gains on sales of investment securities | (1,095) | (1,800) |
| Losses on sales of foreclosed real estate held for resale, including write-downs | 33 | 47 |
| (Increase) decrease in accrued interest receivable | (692) | 295 |
| Earnings on investment in bank owned life insurance | (329) | (349) |
| Impairment charges on equity securities | 14 | |
| Losses on disposals of premises and equipment | 30 | |
| (Increase) decrease in other assets | (1,201) | 49 |
| Increase in accrued interest payable | 31 | 14 |
| Decrease in other liabilities | (2,135) | (3,110) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 4,093 | 1,193 |
| | | |
| INVESTING ACTIVITIES | | |
| Proceeds from sales of investment securities available-for-sale | 79,740 | 120,202 |
| Proceeds from maturities and redemptions of investment securities available-for-sale | 12,727 | 19,243 |
| Purchases of investment securities available-for-sale | (102,185) | (127,704) |
| Proceeds from maturities and redemptions of investment securities held-to-maturity | 1,023 | 8 |
| Net change in restricted investment in bank stocks | (937) | (1,900) |
| Net increase in loans | (17,021) | (16,295) |
| Purchases of premises and equipment | (122) | (400) |
| Proceeds from sales of foreclosed assets held for resale | | 458 |
| NET CASH USED IN INVESTING ACTIVITIES | (26,775) | (6,388) |
| | | |
| FINANCING ACTIVITIES | | |
| Net increase (decrease) in deposits | 4,539 | (47,499) |
| Net increase in short-term borrowings | 15,339 | 20,201 |
| Proceeds from long-term borrowings | 5,000 | 20,000 |

| | | |
|---|---|---|
| Repayment of long-term borrowings | (53) | (5,049) |
| Proceeds from issuance of treasury stock | 32 | |
| Common stock issued | 589 | 539 |
| Dividends paid | (3,011) | (2,874) |
| NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES | 22,435 | (14,682) |
| | | |
| DECREASE IN CASH AND CASH EQUIVALENTS | (247) | (19,877) |
| CASH AND CASH EQUIVALENTS, BEGINNING | 7,967 | 30,623 |
| CASH AND CASH EQUIVALENTS, ENDING | $7,720 | $10,746 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Interest paid | $2,390 | $2,219 |
| Income taxes paid | 1,330 | 1,119 |
| Loans transferred to foreclosed assets held for resale | 226 | 262 |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three and six month periods ended June 30, 2015, are not necessarily indicative of the results for the year ending December 31, 2015. For further information, refer to the consolidated financial statements and notes thereto included in First Keystone Corporation's Annual Report on Form 10-K for the year ended December 31, 2014.

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of June 30, 2015 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

**NOTE 2 RECENT ACCOUNTING STANDARDS UPDATES ("ASU")**

Except as disclosed below, there were no new accounting pronouncements affecting the Corporation during the three and six months ended June 30, 2015 that were not already adopted by the Corporation.

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue requirements in *Revenue Recognition (Topic 605)*. This ASU requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The ASU is effective for annual reporting periods beginning after December 31, 2016, including interim periods within the

reporting period. Early application is not permitted. In July 2015, the FASB approved a one-year delay of the effective date of this standard. The deferral would require public entities to apply the standard for annual reporting periods beginning after December 15, 2017. Public companies would be permitted to elect to early adopt for annual reporting periods beginning after December 15, 2016. The Corporation is currently evaluating the impact of this ASU on its consolidated financial statements.

**NOTE 3 — INVESTMENT SECURITIES**

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

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

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

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at June 30, 2015 and December 31, 2014:

| | Available-for-Sale Securities | | | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| *June 30, 2015*: | | | | |
| U.S. Treasury securities | $6,026 | $ 50 | $ | $6,076 |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | 85,688 | 479 | (605 ) | 85,562 |
| Other | 27,852 | 215 | (25 ) | 28,042 |
| Obligations of state and political subdivisions | 177,476 | 4,389 | (1,512 ) | 180,353 |
| Corporate debt securities | 54,179 | 127 | (1,323 ) | 52,983 |
| Marketable equity securities | 1,194 | 836 | | 2,030 |
| Total | $352,415 | $ 6,096 | $ (3,465 ) | $355,046 |

| | Held-to-Maturity Securities | | | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| *June 30, 2015*: | | | | |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | $ 33 | $ 1 | $ | $ 34 |
| Total | $ 33 | $ 1 | $ | $ 34 |

| | Available-for-Sale Securities | | | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| *December 31, 2014*: | | | | |
| U.S. Treasury securities | $11,356 | $ 24 | $ (2 ) | $11,378 |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | 112,146 | 1,055 | (487 ) | 112,714 |
| Other | 26,246 | 270 | (6 ) | 26,510 |
| Obligations of state and political subdivisions | 151,565 | 6,127 | (469 ) | 157,223 |
| Corporate debt securities | 38,499 | 112 | (825 ) | 37,786 |
| Marketable equity securities | 1,208 | 867 | (20 ) | 2,055 |
| Total | $341,020 | $ 8,455 | $ (1,809 ) | $347,666 |

| *(Dollars in thousands)* | Held-to-Maturity Securities | | | |
|---|---|---|---|---|
| | | Gross | Gross | |
| | Amortized | Unrealized | Unrealized | Fair |
| *December 31, 2014*: | Cost | Gains | Losses | Value |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | $ 56 | $ 2 | $ | $ 58 |
| Other | 1,000 | 2 | | 1,002 |
| Total | $ 1,056 | $ 4 | $ | $ 1,060 |

Securities Available-for-Sale with an aggregate fair value of $241,515,000 at June 30, 2015 and $222,847,000 at December 31, 2014, and securities Held-to-Maturity with an aggregate book value of $33,000 at June 30, 2015 and $1,056,000 at December 31, 2014, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of $175,217,000 at June 30, 2015 and $155,895,000 at December 31, 2014.

The amortized cost, estimated fair value and weighted average yield of debt and equity securities, by contractual maturity, are shown below at June 30, 2015. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

*(Dollars in thousands)*

| | June 30, 2015 Available-For-Sale | | | | | Held-To-Maturity |
|---|---|---|---|---|---|---|
| | U.S. Treasury Securities | U.S. Government Corporations & Agencies Obligations[1] | Obligations of State & Political Subdivisions[2] | Corporate Debt Securities | Marketable Equity Securities[3] | U.S. Government Corporations & Agencies Obligations[1] |
| Within 1 Year: | | | | | | |
| Amortized cost | $ | $ | $ 1,575 | $ 361 | $ | $ |
| Fair value | | | 1,575 | 368 | | |
| Weighted average yield | | | 3.93 % | 3.10 % | | |
| 1 - 5 Years: | | | | | | |
| Amortized cost | 6,026 | 13,846 | 12,087 | 7,265 | | 33 |
| Fair value | 6,076 | 13,861 | 12,300 | 7,187 | | 34 |
| Weighted average yield | 1.32 % | 1.70 % | 3.26 % | 2.21 % | | 2.26 % |
| 5 - 10 Years: | | | | | | |
| Amortized cost | | 32,721 | 85,318 | 46,553 | | |
| Fair value | | 32,752 | 85,393 | 45,428 | | |
| Weighted average yield | | 2.22 % | 3.10 % | 2.69 % | | |
| After 10 Years: | | | | | | |
| Amortized cost | | 66,973 | 78,496 | | 1,194 | |
| Fair value | | 66,991 | 81,085 | | 2,030 | |
| | | 2.22 % | 5.29 % | | 4.92 % | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Weighted average yield | | | | | | |
| | | | | | | |
| Total: | | | | | | |
| Amortized cost | $6,026 | $ 113,540 | $ 177,476 | $ 54,179 | $ 1,194 | $ 33 |
| Fair value | 6,076 | 113,604 | 180,353 | 52,983 | 2,030 | 34 |
| Weighted average yield | 1.32 % | 2.16 % | 4.09 % | 2.63 % | 4.92 % | 2.26 % |

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

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

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

There were no aggregate investments with a single issuer (excluding the U.S. Government and U.S. Government Agencies and Corporations) which exceeded ten percent of consolidated stockholders' equity at June 30, 2015. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities.

Proceeds from sales of investments in Available-for-Sale debt and equity securities for the three months ended June 30, 2015 and 2014 were $31,966,000 and $40,037,000, respectively. Gross gains realized on these sales were $603,000 and $1,514,000, respectively. Gross losses on these sales were $0 and $311,000, respectively. Impairment losses realized on Available-for-Sale equity securities for the three months ended June 30, 2015 and 2014 were $14,000 and $0, respectively.

Proceeds from sales of investments in Available-for-Sale debt and equity securities for the six months ended June 30, 2015 and 2014 were $79,740,000 and $120,202,000, respectively. Gross gains realized on these sales were $1,151,000 and $2,322,000, respectively. Gross losses on these sales were $56,000 and $522,000, respectively. Impairment losses realized on Available-for-Sale equity securities for the six months ended June 30, 2015 and 2014 were $14,000 and $0, respectively.

There were no proceeds from sales of investments in Held-to-Maturity debt and equity securities during the three or six month periods ended June 30, 2015 or 2014. Therefore, there were no gains or losses realized during these periods.

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

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

The fair market value of the equity securities tends to fluctuate with the overall equity markets as well as the trends specific to each institution. The equity securities portfolio is reviewed in a similar manner as that of the debt securities with greater emphasis placed on the length of time the market value has been less than the carrying value and the financial sector outlook. The Corporation also reviews dividend payment activities, levels of non-performing assets and loan loss reserves. The starting point for the equity analysis is the length and severity of market value decline. The

realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment is recognized in other comprehensive income (loss), net of applicable taxes. The previous cost basis less the other-than-temporary impairment recognized in earnings becomes the new cost basis of the investment.

The Corporation and its investment advisors monitor the entire portfolio monthly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. As of June 30, 2015 we recognized other than temporary impairment on one equity security that was trading below cost basis. We have written down the value of the shares based upon market indications. In management's opinion, the equity securities reflect a more accurate valuation of the shares after the impairment charge. Based on the factors described above, management did not consider any other securities to be other-than-temporarily impaired at June 30, 2015. Management did not consider any securities to be other-than-temporarily impaired at December 31, 2014.

In accordance with disclosures required by FASB ASC 320-10-50, *Investments - Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation's investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of June 30, 2015 and December 31, 2014:

June 30, 2015

| *(Dollars in thousands)* | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| Available-for-Sale: | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury securities | $ | $ | $ | $ | $ | $ |
| Obligations of U.S. Government Corporations and Agencies: | | | | | | |
| Mortgage-backed | 43,613 | (377 ) | 12,085 | (228 ) | 55,698 | (605 ) |
| Other | 9,160 | (25 ) | | | 9,160 | (25 ) |
| Obligations of state and political subdivisions | 65,891 | (1,234 ) | 8,815 | (278 ) | 74,706 | (1,512 ) |
| Corporate debt securities | 26,901 | (545 ) | 18,943 | (778 ) | 45,844 | (1,323 ) |
| Marketable equity securities | | | | | | |
| | $ 145,565 | $ (2,181 ) | $ 39,843 | $ (1,284 ) | $ 185,408 | $ (3,465 ) |

December 31, 2014

| *(Dollars in thousands)* | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| Available-for-Sale: | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury securities | $ 6,030 | $ (2 ) | $ | $ | $ 6,030 | $ (2 ) |
| Obligations of U.S. Government Corporations and Agencies: | | | | | | |
| Mortgage-backed | 19,823 | (230 ) | 17,099 | (257 ) | 36,922 | (487 ) |
| Other | 7,154 | (6 ) | | | 7,154 | (6 ) |
| Obligations of state and political subdivisions | 21,459 | (94 ) | 18,273 | (375 ) | 39,732 | (469 ) |
| Corporate debt securities | 22,227 | (542 ) | 12,066 | (283 ) | 34,293 | (825 ) |
| Marketable equity securities | 30 | (20 ) | | | 30 | (20 ) |
| | $ 76,723 | $ (894 ) | $ 47,438 | $ (915 ) | $ 124,161 | $ (1,809 ) |

The Corporation invests in various forms of agency debt including mortgage-backed securities and callable debt. The mortgage-backed securities are issued by FHLMC ("Federal Home Loan Mortgage Corporation"), FNMA ("Federal National Mortgage Association") or GNMA ("Government National Mortgage Association"). The municipal securities consist of general obligations and revenue bonds. The marketable equity securities consist of stocks in other bank holding companies. The fair market value of the above securities is influenced by market interest rates, prepayment

speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation's carrying value at any measurement date. Management does not believe any of their 108 securities with a one year or less unrealized loss position or any of their 20 securities with a greater than one year unrealized loss position as of June 30, 2015, represent an other-than-temporary impairment, as these unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

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

**Loans**

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

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

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

*Commercial and Industrial Lending*

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

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

In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the

borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis of the borrower’s ability to repay.

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

*Commercial Real Estate Lending*

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

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

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

*Residential Real Estate Lending (Including Home Equity)*

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

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

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

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

*Consumer Lending*

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

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

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

**Delinquent Loans**

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

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

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

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

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

**Allowance for Loan Losses**

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

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually classified as impaired. Select loans are not aggregated for collective impairment evaluation, as such; all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular

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

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

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

A reserve for unfunded lending commitments is provided for possible credit losses on off-balance sheet credit exposures. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and, if necessary, is recorded in other liabilities on the Consolidated Balance Sheet. As of June 30, 2015 and December 31, 2014, the amount of the reserve for unfunded lending commitments was $77,000 and $0.

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

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

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

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

Loans modified in a troubled debt restructuring are considered impaired and may or may not be placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrates a period of performance according to the restructured terms of six months.

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

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

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

Risk grade characteristics are as follows:

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

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

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

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

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

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

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

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

They are characterized by the distinct possibility that the Bank will sustain some loss if the aggregate amount of substandard assets is not fully covered by the liquidation of the collateral used as security. Substandard loans have a high probability of payment default; are inadequately protected by the current sound net worth, paying capacity of the borrower, or pledged collateral; and may have other well-defined weaknesses. Such assets require more intensive supervision by Bank Management.

*Risk Grade 9 – DOUBTFUL (Non-Pass Category)*

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

The following table presents the classes of the loan portfolio summarized by risk rating as of June 30, 2015 and December 31, 2014:

| *(Dollars in thousands)* | Commercial and Industrial | | Commercial Real Estate | |
|---|---|---|---|---|
| | June 30, 2015 | December 31, 2014 | June 30, 2015 | December 31, 2014 |
| Grade: | | | | |
| 1-6 Pass | $77,691 | $ 64,459 | $236,691 | $ 237,404 |
| 7 Special Mention | 217 | 47 | 3,030 | 11,008 |
| 8 Substandard | 13 | 21 | 16,188 | 5,472 |
| 9 Doubtful | | | | |
| Add (deduct): Unearned discount and | | | | |
| Net deferred loan fees and costs | 156 | 129 | 275 | 38 |
| Total loans | $78,077 | $ 64,656 | $256,184 | $ 253,922 |

| | Residential Real Estate Including Home Equity | | Consumer Loans | |
|---|---|---|---|---|
| | June 30, 2015 | December 31, 2014 | June 30, 2015 | December 31, 2014 |
| Grade: | | | | |
| 1-6 Pass | $160,201 | $ 161,122 | $5,374 | $ 5,248 |
| 7 Special Mention | 541 | 520 | 2 | 21 |
| 8 Substandard | 1,663 | 1,640 | 7 | 9 |
| 9 Doubtful | | | | |
| Add (deduct): Unearned discount and | | | (27) | (40) |
| Net deferred loan fees and costs | 58 | 271 | 92 | 92 |
| Total loans | $162,463 | $ 163,553 | $5,448 | $ 5,330 |

| | Total Loans | |
|---|---|---|
| | June 30, 2015 | December 31, 2014 |
| Grade: | | |
| 1-6 Pass | $479,957 | $ 468,233 |
| 7 Special Mention | 3,790 | 11,596 |
| 8 Substandard | 17,871 | 7,142 |
| 9 Doubtful | | |
| Add (deduct): Unearned discount and | (27) | (40) |
| Net deferred loan fees and costs | 581 | 530 |
| Total loans | $502,172 | $ 487,461 |

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free loans in the amounts of $43,330,000 and $3,084,000, respectively at June 30, 2015 and $30,334,000 and $3,235,000 at December 31, 2014. Loans held for sale amount to $776,000 at June 30, 2015 and $2,201,000 at December 31, 2014.

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

| *(Dollars in thousands)* | Commercial and Industrial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| As of and for the three month period ended June 30, 2015: | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | $ 687 | $ 3,019 | $ 1,852 | $ 90 | $ 837 | $ 6,485 |
| Charge-offs | | (94 ) | (49 ) | (1 ) | | (144 ) |
| Recoveries | 3 | 42 | | 1 | | 46 |
| Provision | 16 | 172 | 64 | (1 ) | (38 ) | 213 |
| Ending Balance | $ 706 | $ 3,139 | $ 1,867 | $ 89 | $ 799 | $ 6,600 |

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

| *(Dollars in thousands)* | Commercial and Industrial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| As of and for the three month period ended June 30, 2014: | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | $ 825 | $ 3,298 | $ 1,567 | $ 52 | $ 735 | $ 6,477 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Charge-offs | | (96) | (144) | (7) | | (247) |
| Recoveries | 19 | 25 | 2 | 1 | | 47 |
| Provision | (101) | 223 | 194 | 5 | (121) | 200 |
| Ending Balance | $ 743 | $ 3,450 | $ 1,619 | $ 51 | $ 614 | $ 6,477 |

| *(Dollars in thousands)* | Commercial and Industrial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| As of and for the six month period ended June 30, 2014: | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | $ 776 | $ 3,320 | $ 1,565 | $ 53 | $ 805 | $ 6,519 |
| Charge-offs | (7) | (237) | (174) | (15) | | (433) |
| Recoveries | 21 | 25 | 11 | 1 | | 58 |
| Provision | (47) | 342 | 217 | 12 | (191) | 333 |
| Ending Balance | $ 743 | $ 3,450 | $ 1,619 | $ 51 | $ 614 | $ 6,477 |
| Ending balance: individually evaluated for impairment | $ | $ 26 | $ 18 | $ | $ | $ 44 |
| Ending balance: collectively evaluated for impairment | $ 743 | $ 3,424 | $ 1,601 | $ 51 | $ 614 | $ 6,433 |
| | | | | | | |
| Financing Receivables: Ending Balance | $ 60,261 | $ 237,901 | $ 159,559 | $ 5,453 | $ | $ 463,174 |
| Ending balance: individually evaluated for impairment | $ 441 | $ 5,233 | $ 1,217 | $ 7 | $ | $ 6,898 |
| Ending balance: collectively evaluated for impairment | $ 59,820 | $ 232,668 | $ 158,342 | $ 5,446 | $ | $ 456,276 |

| *(Dollars in thousands)* | Commercial and Industrial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| As of December 31, 2014: | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Ending Balance | $ 542 | $ 3,176 | $ 1,928 | $ 107 | $ 637 | $ 6,390 |
| Ending balance: individually evaluated for impairment | $ | $ 38 | $ 81 | $ | $ | $ 119 |
| Ending balance: collectively evaluated for impairment | $ 542 | $ 3,138 | $ 1,847 | $ 107 | $ 637 | $ 6,271 |
| | | | | | | |
| Loan Receivables: | | | | | | |
| Ending Balance | $ 64,656 | $ 253,922 | $ 163,553 | $ 5,330 | $ | $ 487,461 |
| Ending balance: individually evaluated for impairment | $ 399 | $ 5,350 | $ 1,291 | $ 4 | $ | $ 7,044 |
| Ending balance: collectively evaluated for impairment | $ 64,257 | $ 248,572 | $ 162,262 | $ 5,326 | $ | $ 480,417 |

Of the $248,000 in foreclosed assets held for resale at June 30, 2015, three properties totaling $22,000 were secured by commercial real estate and one property in the amount of $226,000 was secured by residential real estate and was held as the result of obtaining physical possession. At December 31, 2014, the $55,000 in foreclosed assets held for resale was secured entirely by commercial real estate, and there were no residential real estate properties held as the result of obtaining physical possession. Consumer mortgage loans secured by residential real estate for which the Bank has entered into formal foreclosure proceedings but for which physical possession has yet to be obtained

amounted to $261,000 at June 30, 2015 and $118,000 at December 31, 2014. These balances were not included in foreclosed assets held for resale at June 30, 2015 or December 31, 2014.

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

The outstanding balance of TDRs as of June 30, 2015 and December 31, 2014 was $9,034,000 and $4,708,000, respectively. The increase in TDRs was attributable to deterioration in the respective borrowers' financial position, and in some cases a declining collateral value, along with the Bank's proactive monitoring of the loan portfolio. As of June 30, 2015 and December 31, 2014, there were no unfunded commitments on any TDRs.

During the three months ended June 30, 2015, three loans with a combined post modification balance of $308,000 were classified as TDRs, as compared to the same period in 2014, when four loans with a combined post modification balance of $476,000 were classified as TDRs. The loan modifications for the three months ended June 30, 2015 consisted of two term modifications and one payment modification. The loan modifications for the three months ended June 30, 2014 consisted of one interest rate modification, two term modifications and one payment modification.

During the six months ended June 30, 2015, five loans with a combined post modification balance of $4,558,000 were classified as TDRs, as compared to the same period in 2014, when nine loans with a combined post modification balance of $922,000 were classified as TDRs. The loan modifications for the six months ended June 30, 2015 consisted of three term modifications and two payment modifications. The loan modifications for the six months ended June 30, 2014 consisted of one interest rate modification, three term modifications, and five payment modifications.

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

*(Dollars in thousands)*

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| Non-accrual TDRs | $ 1,761 | $ 1,638 |
| Accruing TDRs | 7,273 | 3,070 |
| Total | $ 9,034 | $ 4,708 |

At June 30, 2015, five Commercial Real Estate loans classified as TDRs with a combined recorded investment of $6,393,000 were not in compliance with the terms of their restructure, compared to June 30, 2014 when seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of $2,359,000 were not in compliance with the terms of their restructure.

The following table presents information regarding the loan modifications categorized as TDRs during the three and six months ended June 30, 2015 and June 30, 2014:

*(Dollars in thousands, except number of contracts)*

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

*(Dollars in thousands, except number of contracts)*

| | Three Months Ended June 30, 2014 | | | |
|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial | 1 | $ 309 | $ 309 | $ 309 |
| Commercial Real Estate | 3 | 167 | 167 | 166 |
| Consumer | | | | |
| Total | 4 | $ 476 | $ 476 | $ 475 |

*(Dollars in thousands, except number of contracts)*

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

*(Dollars in thousands, except number of contracts)*

| | Six Months Ended June 30, 2014 | | | |
|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial | 2 | $ 327 | $ 327 | $ 327 |
| Commercial Real Estate | 6 | 588 | 588 | 197 |
| Consumer | 1 | 7 | 7 | 7 |
| Total | 9 | $ 922 | $ 922 | $ 531 |

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the three and six months ended June 30, 2015 and June 30, 2014 with the total number of each type of modification performed.

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

| | Three Months Ended June 30, 2014 | | | | Six Months Ended June 30, 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| | Rate Modification | Term Modification | Payment Modification | Number Modified | Rate Modification | Term Modification | Payment Modification | Number Modified |
| Commercial and Industrial | | | 1 | 1 | | | 2 | 2 |
| Commercial Real Estate | 1 | 2 | | 3 | 1 | 3 | 2 | 6 |
| Consumer | | | | | | | 1 | 1 |
| Total | 1 | 2 | 1 | 4 | 1 | 3 | 5 | 9 |

The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended June 30, 2015 and December 31, 2014.

| *(Dollars in thousands)* | June 30, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded: | | | | | | |
| Commercial and Industrial | $414 | $560 | $ | $399 | $545 | $ |
| Commercial Real Estate | 8,917 | 9,161 | | 4,828 | 5,278 | |
| Residential Real Estate | 484 | 593 | | 727 | 892 | |
| Consumer | 2 | 2 | | 4 | 4 | |
| With an allowance recorded: | | | | | | |
| Commercial and Industrial | | | | | | |
| Commercial Real Estate | 257 | 257 | 24 | 522 | 522 | 38 |
| Residential Real Estate | 545 | 550 | 66 | 564 | 569 | 81 |
| Consumer | | | | | | |
| Total | $10,619 | $11,123 | $ 90 | $7,044 | $7,810 | $ 119 |
| Total consists of: | | | | | | |
| Commercial and Industrial | $414 | $560 | $ | $399 | $545 | $ |
| Commercial Real Estate | $9,174 | $9,418 | $ 24 | $5,350 | $5,800 | $ 38 |
| Residential Real Estate | $1,029 | $1,143 | $ 66 | $1,291 | $1,461 | $ 81 |
| Consumer | $2 | $2 | $ | $4 | $4 | $ |

At June 30, 2015 and December 31, 2014, $9,034,000 and $4,708,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of $18,000 and $27,000, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid principal balance is equal to the gross amount due on the loan.

The average recorded investment and interest income recognized for the Corporation's impaired loans are summarized below for the three and six months ended June 30, 2015 and 2014.

| *(Dollars in thousands)* | For the Three Months Ended June 30, 2015 | | For the Three Months Ended June 30, 2014 | |
|---|---|---|---|---|
| | Average Recorded | Interest Income | Average Recorded | Interest Income |

| | Investment | Recognized | Investment | Recognized |
|---|---|---|---|---|
| With no related allowance recorded: | | | | |
| Commercial and Industrial | $ 416 | $ 5 | $ 239 | $ 15 |
| Commercial Real Estate | 8,943 | 141 | 5,205 | 55 |
| Residential Real Estate | 441 | | 1,027 | |
| Consumer | 3 | | 7 | |
| | | | | |
| With an allowance recorded: | | | | |
| Commercial Real Estate | 257 | | 41 | |
| Residential Real Estate | 547 | | 77 | |
| Total | $ 10,607 | $ 146 | $ 6,596 | $ 70 |
| | | | | |
| Total consists of: | | | | |
| Commercial and Industrial | $ 416 | $ 5 | $ 239 | $ 15 |
| Commercial Real Estate | $ 9,200 | $ 141 | $ 5,246 | $ 55 |
| Residential Real Estate | $ 988 | $ | $ 1,104 | $ |
| Consumer | $ 3 | $ | $ 7 | $ |

Of the $146,000 and $70,000 in interest income recognized on impaired loans for the three months ended June 30, 2015 and 2014, respectively, $0 and $2,000 in interest income was recognized in respect to non-accrual loans.

| *(Dollars in thousands)* | For the Six Months Ended June 30, 2015 | | For the Six Months Ended June 30, 2014 | |
|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | |
| Commercial and Industrial | $410 | $ 9 | $166 | $ 15 |
| Commercial Real Estate | 7,599 | 247 | 5,122 | 77 |
| Residential Real Estate | 414 | | 969 | |
| Consumer | 3 | | 5 | |
| | | | | |
| With an allowance recorded: | | | | |
| Commercial Real Estate | 259 | | 40 | |
| Residential Real Estate | 553 | | 77 | |
| Total | $9,238 | $ 256 | $6,379 | $ 92 |
| | | | | |
| Total consists of: | | | | |
| Commercial and Industrial | $410 | $ 9 | $166 | $ 15 |
| Commercial Real Estate | $7,858 | $ 247 | $5,162 | $ 77 |
| Residential Real Estate | $967 | $ | $1,046 | $ |
| Consumer | $3 | $ | $5 | $ |

Of the $256,000 and $92,000 in interest income recognized on impaired loans for the six months ended June 30, 2015 and 2014, respectively, $0 and $2,000 in interest income was recognized in respect to non-accrual loans.

Loan receivables on non-accrual status, foreclosed assets held for resale and loans past-due 90 days or more and still accruing, as of June 30, 2015 and December 31, 2014 were as follows:

*(Dollars in thousands)*

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| Commercial and Industrial | $ | $ 5 |
| Commercial Real Estate | 2,317 | 2,678 |
| Residential Real Estate | 1,029 | 1,291 |
| Total non-accrual loans | 3,346 | 3,974 |
| Foreclosed assets held for resale | 248 | 55 |
| Loans past-due 90 days or more and still accruing | 280 | 10 |
| Total non-performing assets | $ 3,874 | $ 4,039 |

The following tables present the classes of the loan portfolio summarized by the past-due status at June 30, 2015 and December 31, 2014:

*(Dollars in thousands)*

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Total Loans | 90 Days Or Greater Past Due and Still Accruing |
|---|---|---|---|---|---|---|---|
| June 30, 2015: | | | | | | | |
| Commercial and Industrial | $ 187 | $ 23 | $ | $ 210 | $ 77,867 | $ 78,077 | $ |
| Commercial Real Estate | 1,290 | 4,265 | 2,469 | 8,024 | 248,160 | 256,184 | 280 |
| Residential Real Estate | 1,043 | 920 | 883 | 2,846 | 159,617 | 162,463 | |
| Consumer | 9 | 12 | | 21 | 5,427 | 5,448 | |
| Total | $ 2,529 | $ 5,220 | $ 3,352 | $ 11,101 | $ 491,071 | $ 502,172 | $ 280 |

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*(Dollars in thousands)*

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Total Loans | 90 Days Or Greater Past Due and Still Accruing |
|---|---|---|---|---|---|---|---|
| December 31, 2014: | | | | | | | |
| Commercial and Industrial | $ 72 | $ 28 | $ 5 | $ | | | |