FIRST KEYSTONE CORP
Form 10-K
March 15, 2012

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, 2011**

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, 2011 determined by using a per share closing price on that date of $19.01 as quoted on the Over the Counter Bulletin Board, was $96,179,000.

At March 1, 2012 there were 5,446,037 shares of Common Stock, $2.00 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's 2012 definitive Proxy Statement are incorporated by reference in Part III of this Report.

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PART I

Forward Looking Statements

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements, which are included pursuant to the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in 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 Keystone National Bank (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, 2011, 2010, and 2009, and was the only reportable segment. At December 31, 2011, the Corporation had total consolidated assets, deposits and stockholders' equity of approximately $819 million, $624 million and $93 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.

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. 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, 2011, the Bank had 179, full-time employees and 28 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 Danville, Pennsylvania in Montour County along the Interstate 80 corridor east to Stroudsburg, Pennsylvania in Monroe County. It also expands north from the Interstate 80/Interstate 81 interchange to Kingston, Pennsylvania in Luzerne, Pennsylvania.

Competition - Bank

The Bank competes actively with other area commercial banks and savings and loan associations, many of which are larger than the Bank, as well as with major regional banking and 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
- Sovereign Bank
- Citizens Bank
- ESSA Bank & Trust
- First National Community Bank
- Wayne Bank

Credit unions are also competitors, 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, 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 the FDIC.

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 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, 2011, the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category.

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 FDICIA

Each depository institution must submit audited financial statements to its primary regulator and the FDIC, which 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 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

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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

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, 2011.

(In Thousands)

Tier I Capital	$ 65,209	
Tier II Capital	6,004	
Total Capital	$ 71,213	
Adjusted Total Average Assets	$ 807,792	
Total Adjusted Risk-Weighted Assets[1]	$ 543,901	
Tier I Risk-Based Capital Ratio[2]	11.99	%
Required Tier I Risk-Based Capital Ratio	4.00	%
Excess Tier I Risk-Based Capital Ratio	7.99	%
Total Risk-Based Capital Ratio[3]	13.09	%
Required Total Risk-Based Capital Ratio	8.00	%
Excess Total Risk-Based Capital Ratio	5.09	%
Tier I Leverage Ratio[4]	8.07	%
Required Tier I Leverage Ratio	4.00	%
Excess Tier I Leverage Ratio	4.07	%

[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 32 of this report.

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. First Keystone Community 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.

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.

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 Securities Exchange Act of 1934. 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 gives 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 Securities Exchange Act of 1934. The Corporation is subject to the informational requirements of the Exchange Act, and, accordingly, files reports, proxy statements and other information with the SEC. The reports, proxy statements and other information filed with the SEC are available for inspection and copying at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at

1-800-SEC-0330. The Corporation is an electronic filer with the SEC. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC’s internet site address is www.sec.gov.

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

ITEM 1A. RISK FACTORS

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

The Corporation Is Subject To Interest Rate Risk.

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

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

The Corporation’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. Such competitors primarily include national, regional and community banks within the various markets in which the Corporation operates. Additionally, various out-of-state banks have begun to enter or have announced plans to enter the market areas in which the Corporation currently operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, savings and loans, 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 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 currently not 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, 2011, approximately 66.8% 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, 2011, its allowance for loan losses totaled $5.9 million, representing 1.44% 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 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 generally is 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.

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ITEM 2. PROPERTIES

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

Properties owned are:

- Main Office located at 111 West Front Street, Berwick, Pennsylvania 18603;
- Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;
- Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
- Scott Township Office located at 2301 Columbia Boulevard, Bloomsburg, Pennsylvania 17815;
- Mifflinville Office located at Third and Race Streets, Mifflinville, Pennsylvania 18631;
- Hanover Township Office located at 1540 Sans Souci 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;
- Vacant lot held for expansion located at 117-119 West Front Street, Berwick, Pennsylvania 18603;
- Parking lot located at Second and Market Streets, Berwick, Pennsylvania 18603; and
- 18 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;
- Kingston Office located at 179 South Wyoming Avenue, Kingston, Pennsylvania 18704;
- 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, 2010; 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
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
2010:			
First quarter	$ 17.25	$ 15.77	$ .23
Second quarter	$ 17.49	$ 15.50	$ .23
Third quarter	$ 16.75	$ 15.50	$ .23
Fourth quarter	$ 17.50	$ 15.90	$ .24

As of December 31, 2011, the Corporation had approximately 877 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, 2006, through and including December 31, 2011, 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, 2006, 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					
	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
First Keystone Corporation	100.00	92.10	89.35	110.98	120.82	149.00
NASDAQ - Total US	100.00	110.66	66.42	96.54	114.06	113.16
SNL $500M- $1B Bank Index	100.00	80.13	51.35	48.90	53.38	46.96

[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.

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ITEM 6. SELECTED FINANCIAL DATA

(Amounts in thousands, except per share)

	Year Ended December 31,				
	2011	2010	2009	2008	2007
SELECTED FINANCIAL DATA:					
Total assets	$818,546	$796,601	$758,330	$714,898	$681,207
Total investment securities	336,618	316,531	282,798	243,165	246,059
Net loans	410,066	403,950	401,375	403,172	371,557
Total deposits	624,349	626,895	580,569	504,633	493,041
Total long-term borrowings	64,339	66,400	82,976	82,062	66,175
Stockholders' equity	93,092	79,060	74,167	69,147	70,924
SELECTED OPERATING DATA:					
Interest income	$37,028	$38,154	$37,726	$37,638	$31,899
Interest expense	9,405	12,742	15,565	18,116	17,785
Net interest income	27,623	25,412	22,161	19,522	14,114
Provision for loan losses	1,900	2,575	800	700	150
Net interest income after provision for loan losses	25,723	22,837	21,361	18,822	13,964
Non-interest income	4,431	5,758	4,299	4,046	4,199
Non-interest expense	17,695	17,272	16,444	13,923	10,645
Income before income taxes	12,459	11,323	9,216	8,945	7,518
Income tax expense	2,552	2,362	1,279	1,394	1,391
Net income	$9,907	$8,961	$7,937	$7,551	$6,127
PER COMMON SHARE DATA:					
Net income	$1.82	$1.65	$1.46	$1.39	$1.31
Cash dividends	.97	.93	.92	.89	.88
PERFORMANCE RATIOS:					
Return on average assets	1.21 %	1.09 %	1.06 %	1.08 %	1.09 %
Return on average equity	11.57 %	10.98 %	10.88 %	10.72 %	10.48 %
Dividend payout	53.31 %	56.47 %	63.06 %	64.12 %	68.25 %
Average equity to average assets	10.43 %	9.95 %	9.73 %	10.00 %	10.37 %

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, 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 an increase of $3,061,000, or 12.7% to $27,234,000 in 2010.

Year Ended December 31, 2010 Versus Year Ended December 31, 2009

Net income increased to $8,961,000 for the year ended December 31, 2010, as compared to $7,937,000 for the prior year, an increase of 12.9%. Earnings per share, both basic and diluted, for 2010 were $1.65 as compared to $1.46 in 2009, an increase of 13.0%. Cash dividends per share increased to $.93 in 2010 from $.92 in 2009, an increase of 1.1%. The Corporation's return on average assets was 1.1% in 2010 as compared to 1.1% in 2009. Return on average equity increased to 11.0% in 2010 from 10.9% in 2009. An increase in earning asset levels resulted in an overall increase of interest income to $38,154,000, up $428,000 or 1.1% from 2009. There was the accompanying decrease in interest on deposits and borrowings as interest rates declined, which resulted in interest expense of $12,742,000 in 2010, a decrease of $2,823,000 or 18.1% from 2009.

Net interest income, as indicated below in Table 1, increased by $3,251,000 or 14.7% to $25,412,000 for the year ended December 31, 2010. The Corporation's net interest income on a fully taxable equivalent basis increased by $3,061,000, or 12.7% to $27,234,000 in 2010 as compared to an increase of $2,763,000, or 12.9% to $24,173,000 in 2009.

Table 1 — Net Interest Income

(Amounts in thousands)		2011/2010 Increase/(Decrease)			2010/2009 Increase/(Decrease)		
	2011	Amount	%	2010	Amount	%	2009
Interest Income	$37,028	$(1,126)	(2.9)	$38,154	$428	1.1	$37,726
Interest Expense	9,405	(3,337)	(26.2)	12,742	(2,823)	(18.1)	15,565
Net Interest Income	27,623	2,211	8.7	25,412	3,251	14.7	22,161
Tax Equivalent Adjustment	2,274	452	24.8	1,822	(190)	(9.4)	2,012
Net Interest Income (fully tax equivalent)	$29,897	$2,663	9.8	$27,234	$3,061	12.7	$24,173

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

	2011 Average Balance	Revenue/ Expense	Yield/ Rate	2010 Average Balance	Revenue/ Expense	Yield/ Rate	2009 Average Balance	Revenue/ Expense	Yield/ Rate
Interest Earning Assets:									
Loans:									
Commercial, net[1,2]	$40,883	$2,214	5.42 %	$41,246	$2,307	5.59 %	$48,286	$2,664	5.52 %
Real Estate[1]	364,099	20,427	5.61 %	360,481	21,164	5.87 %	347,992	21,420	6.16 %
Consumer, Net[1,2]	7,561	643	8.50 %	8,700	717	8.24 %	12,170	922	7.58 %
Fees on Loans	—	454	— %	—	478	— %	—	149	— %
Total Loans (Including Fees)[3]	$412,543	$23,738	5.75 %	$410,427	$24,666	6.01 %	$408,448	$25,155	6.16 %
Investment Securities:									
Taxable	$234,410	$9,790	4.18 %	$225,670	$10,502	4.65 %	$175,042	$9,347	5.34 %
Tax Exempt[1]	87,427	5,769	6.60 %	72,477	4,780	6.60 %	78,277	5,227	6.68 %
Total Investment Securities	321,837	15,559	4.83 %	298,147	15,282	5.13 %	253,319	14,574	5.75 %
Interest Bearing Deposits in Banks	13,840	4	0.03 %	39,638	24	0.06 %	18,457	9	0.05 %
Federal Funds Sold	565	1	0.18 %	1,521	4	0.26 %	—	—	— %
Total Other Interest Earning Assets	14,405	5	0.03 %	41,159	28	0.07 %	18,457	9	0.05 %
Total Interest Earning Assets	$748,785	$39,302	5.25 %	$749,733	$39,976	5.33 %	$680,224	$39,738	5.84 %
Non-Interest Earning Assets:									
Cash and Due From Banks	$6,050			$3,980			$6,943		
Allowance for Loan Losses	(5,711)			(5,286)			(5,221)		
Premises and Equipment	12,072			11,816			10,515		
Foreclosed Assets Held for Sale	1,208			466			78		
Other Assets	58,744			58,916			57,259		
Total Non-Interest Earning Assets	72,363			69,892			69,574		
Total Assets	$821,148			$819,625			$749,798		
Interest Bearing Liabilities:									
Savings, NOW Accounts, and Money	$308,778	$1,721	0.56 %	$288,431	$2,717	0.94 %	$220,845	$2,491	1.13 %

Markets									
Time Deposits	249,543	4,997	2.00 %	269,075	6,394	2.38 %	280,005	8,873	3.17 %
Short-Term Borrowings	2,316	7	0.30 %	1,189	—	— %	4,918	31	0.63 %
Long-Term Borrowings	68,356	2,523	3.69 %	80,735	3,401	4.21 %	79,899	3,830	4.79 %
Fed Funds Purchased	—	—	— %	—	—	— %	118	2	1.69 %
Securities Sold U/A to Repurchase	21,593	157	0.73 %	19,442	230	1.18 %	19,268	338	1.75 %
Total Interest Bearing Liabilities	$650,586	$9,405	1.45 %	$658,872	$12,742	1.93 %	$605,053	$15,565	2.57 %
Non-Interest Bearing Liabilities:									
Demand Deposits	$71,661			$65,831			$58,860		
Other Liabilities	13,292			13,337			12,959		
Stockholders' Equity	85,609			81,585			72,926		
Total Liabilities/Stockholders' Equity	$821,148			$819,625			$749,798		
Net Interest Income Tax Equivalent		$29,897			$27,234			$24,173	
Net Interest Spread			3.80 %			3.40 %			3.27 %
Net Interest Margin			3.99 %			3.63 %			3.55 %

[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.

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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 2011, 2010 and 2009.

The yield on earning assets was 5.25% in 2011, 5.33% in 2010, and 5.84% in 2009. The rate paid on interest bearing liabilities was 1.45% in 2011, 1.93% in 2010, and 2.57% in 2009. This resulted in an increase in our net interest spread to 3.80% in 2011, as compared to 3.40% in 2010 and 3.27% in 2009.

As Table 2 illustrates, the net interest margin, which is interest income less interest expense divided by average earnings assets, was 3.99% in 2011 as compared to 3.63% in 2010 and 3.55% in 2009. The net interest margins are presented on a tax-equivalent basis. In 2011, yield on earning assets fell by 0.08%, from 5.33% to 5.25% while the rate paid on interest bearing liabilities dropped 0.48%. The Bank is liability sensitive, meaning that its liabilities reprice more quickly than its assets. This is the reason for the 0.40% increase in net interest spread. The increase in spread and margin in 2010 as compared to 2009 was similarly caused by falling rates. Interest income exempt from federal tax was $4,617,000 in 2011, $3,771,000 in 2010, and $4,261,000 in 2009. 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 2011 and 2010. The interest margin expansion was experienced as the yield curve retained its upward slope during 2011. Our improved net interest margin will be under pressure when interest rates start to rise since the Corporation continues to be liability sensitive and 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 has focused on attracting lower cost checking, savings and money market accounts and reduced 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 2011, the increase in net interest income on a fully tax equivalent basis 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. In 2010, the increase in net interest income of $3,061,000 resulted from an increase in volume of $2,016,000 and an increase of $1,045,000 due to changes in rate.

Table 3 — Changes in Income and Expense, 2011 and 2010

(Amounts in thousands)	2011 COMPARED TO 2010			2010 COMPARED TO 2009		
	VOLUME	RATE	NET	VOLUME	RATE	NET
Interest Income:						
Loans, Net	$127	$(1,054)	$(927)	$122	$(611)	$(489)
Taxable Investment Securities	407	(1,119)	(712)	2,703	(1,548)	1,155
Tax-Exempt Investment Securities	986	3	989	(387)	(60)	(447)
Other Short-Term Investments	(18)	(6)	(24)	11	8	19
Total Interest Income	$1,502	$(2,176)	$(674)	$2,449	$(2,211)	$238
Interest Expense:						
Savings, Now and Money Markets	$192	$(1,188)	$(996)	$762	$(536)	$226
Time Deposits	(464)	(934)	(1,398)	(346)	(2,133)	(2,479)
Short-Term Borrowings	—	7	7	(26)	(7)	(33)
Long-Term Borrowings	(521)	(357)	(878)	40	(469)	(429)
Securities Sold U/A to Repurchase	25	(97)	(72)	3	(111)	(108)
Total Interest Expense	(768)	(2,569)	(3,337)	433	(3,256)	(2,823)
Net Interest Income	$2,270	$393	$2,663	$2,016	$1,045	$3,061

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, 2011, the provision for loan losses was $1,900,000 as compared to $2,575,000 as of December 31, 2010 and $800,000 as of December 31, 2009. The provision in 2011 decreased primarily because net charge-offs decreased. Net charge-offs by the Corporation for the fiscal years ended December 31, 2011, 2010 and 2009, were $1,672,000, $2,196,000, and $673,000, respectively. See Allowance for Loan Losses on Page 28 for further discussion.

The Corporation did not change the manner 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 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 2012 if economic conditions continue to be unfavorable.

The allowance for loan losses as a percentage of loans, net of unearned interest, was 1.43% as of December 31, 2011, 1.39% as of December 31, 2010 and 1.31% as of December 31, 2009.

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 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 the gain on the sale of mortgage loans. In addition, investment securities gains or losses also impact total non-interest income.

Non-interest income through December 31, 2011 was $4,431,000, a decrease of 23.0%, or $1,327,000, from 2010. Table 4 provides the major categories of non-interest income and each respective change comparing the last three years. 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. In 2010 non-interest income was $5,758,000 which was an increase of $1,459,000 from 2009. The increase from 2009 to 2010 was due to changes in the same items.

During 2011, the Corporation recorded a net gain of $111,000 from sales of securities in its investment portfolio. This was $52,000 less than in 2010 and resulted from the sale of municipal taxable and tax-free bonds at a gain and was offset in part by sales of equity securities at a loss. In 2010, net gain on the sale of investment securities was $163,000 as compared to a net loss of $138,000 during 2009. In 2010, the gains were also the result of sales of municipal securities at a net gain.

The Corporation performs a quarterly impairment analysis. The analysis includes a review of investment securities owned by our subsidiary, First Keystone Community Bank, and a review of bank equities 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 equities 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 financial institution equities owned is considered in making an impairment charge decision.

Excluding investment securities gains (losses) and the recovery on loss due to defalcation, non-interest income fell by $475,000 in 2011 as compared to 2010, a 9.9% decline. The major factors in the reduction were lower gains on the sale of residential mortgage loans, lower service charges on deposits, and lower trust department income.

The gain on the sale of mortgage loans provided $368,000 in 2011 as compared to $825,000 in 2010 and $300,000 in 2009. 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 gain on sale 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, consisting primarily of service charges on deposit accounts and ATM and debit card income, were the largest source of non-interest income in 2011 and 2010. Service charges and fees were lower by $70,000 in 2011 than in 2010, or 3.1%. During 2011, overdraft fees on demand deposit accounts fell, causing a reduction in fees of more than $150,000. Service charges and fees decreased $58,000 in 2010 as compared to 2009, primarily due to a reduction in non-sufficient fund ("NSF") fees.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit products, and miscellaneous fees, increased $117,000 or 43.3% in 2011 and decreased $293,000 or 52.0% in 2010. Other non-interest income rose in 2011, which was caused in large measure by an increase in commissions earned on sales of retail non-deposit investment products. In 2009, the increased sale of non-deposit products, especially annuities, and the proceeds from a bank owned life insurance policy on a deceased employee, accounted for the majority of the 2009 increase. 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)		2011/2010 Increase/(Decrease)			2010/2009 Increase/(Decrease)		
	2011	Amount	%	2010	Amount	%	2009
Trust department	$585	$(56)	(8.7)	$ 641	$166	34.9	$475
Service charges and fees	2,223	(70)	(3.1)	2,293	(58)	(2.5)	2,351
Income on bank owned life insurance	757	(9)	(1.2)	766	18	2.4	748
Gain on sale of mortgage loans	368	(457)	(55.4)	825	525	175.0	300
Other	387	117	43.3	270	(293)	(52.0)	563
Recovery on loss due to defalcation	—	(800)	N/A	800	800	N/A	—
Subtotal	4,320	(1,275)	(22.8)	5,595	1,158	26.1	4,437
Investment securities gains (losses)-net	111	(52)	(31.9)	163	301	218.1	(138)
Total	$4,431	$(1,327)	(23.0)	$ 5,758	$1,459	33.9	$4,299

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 $17,695,000, an increase of $423,000, or 2.5% in 2011 compared to an increase of $828,000, or 5.0% in 2010. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to 53.6% of total non-interest expense in 2011 and 52.4% in 2010. Salaries and employee benefits increased $431,000, or 4.8% in 2011 and $993,000, or 12.3% in 2010. 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. In 2010, salaries increased due in large part to several new positions related to maintenance of regulatory compliance and normal salary increases. Health insurance increases added $40,000 to employee benefits in 2011 and $195,000 in 2010. The number of full time equivalent employees was 190 as of December 31, 2011, and 180 as of December 31, 2010.

Net occupancy expense increased $64,000, or 4.9% in 2011 as compared to an increase of $130,000, or 11.1% in 2010. Furniture and equipment and computer expense increased $73,000, or 5.4% in 2011 compared to an increase of $217,000, or 18.9% in 2010. 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

$242,000, or 27.6% in 2011 as compared to a decrease of $308,000, or 26.0% in 2010. Other non-interest expenses, including shares tax, ATM and debit card fees and professional services, increased $97,000, or 2.1% in 2011 after increasing $646,000, or 16.0% in 2010. The increase in other non-interest expense in 2010 relates to an increase in accounting, auditing and professional services fees.

Management of the Corporation believes that investors' understanding of the Corporation's performance is enhanced by disclosing non-GAAP financial measures without the effect of the loss due to defalcation as a reasonable basis for comparison of the Corporation's ongoing results of operations. These non-GAAP measures should not be considered a substitute for GAAP-basis measures and results. Our non-GAAP measures may not be comparable to non-GAAP measures of other companies. The following Non-GAAP Reconciliation Schedule provides a reconciliation of these non-GAAP financial measures to the most closely analogous measure determined in accordance with GAAP.

NON-GAAP RECONCILIATION SCHEDULE

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

(Unaudited)

(In Thousands)

	For the Year Ended December 31, 2011	2010
Net interest income after provision for loan losses	$25,723	$22,837
Non-interest income	4,431	5,758
Non-interest expense	(17,695)	(17,272)
Income tax expense	(2,552)	(2,362)
Net Income	9,907	8,961
Adjustments		
Other income		
Recovery on loss due to defalcation	—	(800)
Income tax expense	—	272
After tax adjustment to GAAP	—	(528)
Adjusted net income	$9,907	$8,433

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 2.15% and 2.11% of average assets in 2011 and 2010, 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)	2011	2011/2010 Increase/(Decrease) Amount	%	2010	2010/2009 Increase/(Decrease) Amount	%	2009
Salaries and employee benefits	$9,480	$ 431	4.8	$9,049	$993	12.3	$8,056
Occupancy, net	1,364	64	4.9	1,300	130	11.1	1,170
Furniture and equipment and computer expense	1,436	73	5.4	1,363	217	18.9	1,146
FDIC Insurance	634	(242)	(27.6)	876	(308)	(26.0)	1,184
Loss due to defalcation	—	—	N/A	—	(850)	N/A	850
Other	4,781	97	2.1	4,684	646	16.0	4,038

Total	$17,695	$ 423	2.5	$17,272	$828	5.0	$16,444

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2011, was $2,552,000 as compared to $2,362,000 and $1,279,000 for the years ended December 31, 2010 and 2009, respectively. The effective income tax rate was 20.5% in 2011, 20.9% in 2010, and 13.9% in 2009. The limited availability of tax-free municipal investments at attractive interest rates may result in a higher effective tax rate in future years. The tax rate in 2011 was just slightly lower than 2010. The increase in the tax rate from 2009 to 2010 was the result of a reduction in tax-free municipal securities held in our investment portfolio. 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.

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FINANCIAL CONDITION

GENERAL

Total assets increased to $818,546,000 at year-end 2011, an increase of 2.8% from year-end 2010. As of December 31, 2011, total deposits amounted to $624,349,000, a decrease of 0.4% over 2010. Total assets as of December 31, 2010 were $796,601,000, an increase of 5.1% over 2009, while total deposits as of year-end 2010 amounted to $626,895,000, an increase of 8.0% from 2009.

In 2011 and 2010, because of the economy and the continuing lack of loan demand, excess cash was deployed in the investment portfolio.

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 2011 by $7,844,000 after decreasing in 2010 by $13,061,000. 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 91.2% for 2011, compared to 91.5% for 2010 and 90.7% for 2009. 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 $415,995,000 as of December 31, 2011, as compared to a balance of $409,651,000 as of December 31, 2010. 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 $6,344,000, or 1.6% in 2011 compared to an increase of $2,954,000, or 0.7% in 2010.

The economy and the resultant decline in loan demand account for the slow growth in the loan portfolio in 2011. Residential real estate loans decreased to $130,718,000 as of December 31, 2011, as compared to $131,981,000 as of December 31, 2010. The majority of the decline was the result of originating and selling secondary market conforming mortgage loans rather than holding them in the Bank's portfolio. The Corporation did not change its underwriting standards in 2011, rather opportunities to originate commercial and consumer loans declined because of the economy and the increased unemployment in our market area.

The loan portfolio is well diversified. The total commercial portfolio was $277,872,000 of which $238,186,000 or 57.3% of gross loans is secured by commercial real estate.

The largest relationship is an $8,500,000 tax-free loan to a municipality founded in 1816 consisting of 35 square miles, which is located in the eastern region of our market area. According to township officials, the township experienced 17% growth in population from 2001 through 2010 and future job growth is projected to be 29% over the next 10 years. The township is currently involved in a $70,000,000 sewer expansion project. The Bank's loan is secured by project receivables and the full faith, credit and taxing power of the township.

The second largest relationship of $7,479,000 is comprised of loans to individuals and their related companies involved in the ownership and operation of gas stations, convenience stores, and truck stops located in northern, central and eastern Pennsylvania. The borrowers are well experienced in the industry and have been operating various locations since 1988. The loans are secured by commercial real estate, and perfected security interest in all business assets.

The third largest relationship is a real estate development company and its related entities, specializing in the design, construction and management of student housing units. The company was established in the late 1980s and its primary market is our immediate central market. The relationship had outstanding loan balances of $7,119,000 at December 31, 2011, and is secured primarily by income producing real estate.

The fourth largest relationship is a real estate holding LLC established in 2006, and its related medical service companies. The LLC was formed to construct and provide medical office space for a group of closely related medical entities and outside services and is located in the Corporation's immediate central market area. The relationship had outstanding loan balances of $6,921,000 at December 31, 2011, secured primarily by commercial real estate and perfected security interest in all business assets of the various related entities. A small portion of the relationship is to an individual $45,000 secured by vehicles.

The fifth largest relationship consisted of the net balance of $5,964,000 after participations sold of $3,301,000, and letters of credit of $2,331,000. This relationship is comprised of a $5,000,000 revolving line of credit with related letters of credit to develop a Planned Residential Community in the eastern portion of our market area; a $72,000 residential mortgage; the unsold principal balance of several commercial mortgages secured by investment properties totaling $442,000; and a $450,000 revolving line of credit for working capital. The borrowers and their related companies have been involved in real estate development since 1974, and have developed residential communities and medical and professional office space. The entire relationship is secured by a combination of real estate and marketable securities.

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.

Increases in the portfolio in 2011 were primarily in commercial real estate loans. There was a decrease in commercial loans - other. These are loans to corporations and businesses not secured by real estate. 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 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,				
	2011	2010	2009	2008	2007
Commercial, financial and agricultural:					
Commercial secured by real estate	$236,645	$227,147	$203,413	$206,095	$190,803
Commercial - other	21,448	29,693	42,815	33,104	29,129
Tax exempt - real estate and other	19,779	12,450	12,525	18,920	10,899
Real estate (primarily residential mortgage loans)	130,718	131,981	138,092	136,288	130,865
Consumer loans	7,429	8,781	10,802	15,291	16,712
Total Gross Loans	$416,019	$410,052	$407,647	$409,698	$378,408
Less: Unearned income and unamortized loan fees net of costs	24	401	950	1,331	1,805
Total Loans, net of unearned income	$415,995	$409,651	$406,697	$408,367	$376,603

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 increased $23,748,000 or 7.7% to $334,013,000 in 2011 as excess cash was directed to the investment portfolio in the face of low loan demand. Available-for-sale securities increased $32,441,000, or 11.7% to $310,265,000 in 2010. At December 31, 2011, the net unrealized gain, net of the tax effect, on these securities was $7,757,000 and is included in stockholders' equity as accumulated other comprehensive income (loss). At December 31, 2010, accumulated other comprehensive income (loss), net of tax effect, amounted to a loss of $1,633,000. In 2011, held-to-maturity securities decreased $3,661,000, or 58.4% to $2,605,000 after increasing $1,292,000, or 26.0% in 2010. The reduction in held-to-maturity securities was primarily due to a $630,000 matured bond and $3,000,000 of called bonds. 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.

In 2011, the Corporation increased investments in U.S. Government corporations and agencies, including mortgage backed securities and decreased investments in corporate securities in order to attain more attractive yields.

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, 2011. 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 22 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, 2011, the investment portfolio does not contain any off-balance sheet derivatives or trust preferred investments.

During 2011, interest bearing deposits in other banks decreased to $1,776,000 from $4,559,000 in 2010 and from $7,227,000 in 2009. In 2011, as in 2010 the decrease in interest bearing deposits in other banks 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,					
	2011		2010		2009	
	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity
U. S. Government corporations and agencies	$81,056	$ 2,138	$51,873	$ 5,169	$59,422	$ 3,159
Obligations of state and political subdivisions	186,785	467	177,252	1,097	162,600	1,815
Corporate securities	59,242	—	72,952	—	45,904	—
Marketable equity securities	1,741	—	1,825	—	1,759	—
Restricted equity securities	5,189	—	6,363	—	8,139	—
Total	$334,013	$ 2,605	$310,265	$ 6,266	$277,824	$ 4,974

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2011, the allowance for loan losses was $5,929,000 as compared to $5,701,000 and $5,322,000 as of December 31, 2010 and 2009, respectively. 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 our Allowance for Loan Losses indicating charge-offs and recoveries by the year and annual additional provisions charged to operations. In 2011, net charge-offs as a percentage of average loans were 0.4%, in 2010 net charge-offs as a percentage of average loans were 0.5% compared to 0.2% in 2009. Net charge-offs amounted to $1,672,000 in 2011, $2,196,000 in 2010 and $673,000 in 2009. The decrease in net charge-offs in 2011 relates primarily to decreased losses of commercial loans secured by real estate when compared to previous years. The largest relationship of $711,000, represents 42.5% of net charge-offs in 2011, is located in the eastern central portion of our market area and was directly related to the food service industry. The downturn in the economy resulted in a significant reduction in consumers' disposable income, which impacted this industry. The next largest group of loan relationships, representing 27.3%, of net charge-offs in 2011 was related to several small commercial and industrial relationships, which were negatively affected with the economic downturn and resulted in losses. The resulting charge-offs required an additional provision in the fourth quarter of 2011. The increase in net charge-offs in 2010 relate primarily to increased losses on commercial loans, real estate loans and consumer loans. In 2009, the charge-offs were related to the downturn in the economy and the housing industry in commercial loans, and the economy in general in the consumer portfolio.

For the year ended December 31, 2011, the provision for loan losses was $1,900,000 as compared to $2,575,000 for 2010 and $800,000 for 2009. The provision, net of charge-offs and recoveries, increased the year-end Allowance for

Loan Losses to $5,929,000 of which 8.3% was attributed to the Commercial-other component; 59.1% attributed to Commercial Real Estate component; 2.3% attributed to the Consumer component; 20.7% attributed to Real estate (primarily residential mortgage loans) component and 9.6% being the unallocated component (refer to the activity in the allowance for loan losses table in Note 4 — Loans on page 59). The Allowance for Loan losses as of December 31, 2011 increased from $5,701,000 as of December 31, 2010. The Corporation determined that the provision for loan losses made during 2011 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, 2011.

Table 8 — Analysis of Allowance for Loan Losses

(Amounts in thousands)	Years Ended December 31,				
	2011	2010	2009	2008	2007
Balance at beginning of period	$5,701	$5,322	$5,195	$5,046	$3,671
Charge-offs:					
Commercial, financial and agricultural	485	389	211	44	12
Real estate	1,186	1,778	354	633	138
Consumer	98	95	169	62	86
	1,769	2,262	734	739	236
Recoveries:					
Commercial, financial and agricultural	28	39	13	154	135
Real estate	53	13	25	6	11
Consumer	16	14	23	28	33
	97	66	61	188	179
Net charge-offs	1,672	2,196	673	551	57
Additions charged to operations	1,900	2,575	800	700	150
Allowance purchased	—	—	—	—	1,282
Balance at end of period	$5,929	$5,701	$5,322	$5,195	$5,046
Ratio of net charge-offs during the period to average loans outstanding during the period	0.4 %	0.5 %	0.2 %	0.1 %	0.02 %
Allowance for loan losses to average loans outstanding during the period	1.44 %	1.39 %	1.30 %	1.33 %	1.82 %

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 1.44% in 2011, 1.39% in 2010 and 1.30% in 2009.

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,									
	2011	%*	2010	%*	2009	%*	2008	%*	2007	%*
Commercial, financial and agricultural	$489	9.1	$565	11.4	$970	19.3	$721	15.8	$1,116	22.8
Real estate - mortgage	4,735	88.3	4,270	86.1	3,948	78.7	3,641	79.7	3,680	75.1
Consumer and other loans	137	2.6	123	2.5	99	2.0	207	4.5	103	2.1
Unallocated	568	N/A	743	N/A	305	N/A	626	N/A	147	N/A
	$5,929	100.0	$5,701	100.0	$5,322	100.0	$5,195	100.0	$5,046	100.0

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

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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. Restructured loans are loans where the borrower has been granted a concession in the interest rate or payment amount because of financial problems. Foreclosed assets held for sale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

The total of non-performing assets decreased to $4,968,000 in 2011 after increasing to $5,425,000 as of December 31, 2010 and from $3,418,000 as of December 31, 2009. The economy, in particular, increased unemployment and the downturn of the housing industry had a direct effect of increasing 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 2011 and 2010, are projected to continue higher than normal into 2012. Impaired loans decreased to $4,188,000 in 2011 from $4,276,000 in 2010 as compared to 2009 from $2,948,000 in 2009. Foreclosed assets decreased to $780,000 in 2011 from $1,149,000 in 2010. Loans past-due 90 days or more and still accruing remained unchanged at $0 in 2011 and 2010, decreasing from $140,000 in 2009. Non-performing assets to period end loans and foreclosed assets was 1.2% in 2011, 1.3% in 2010, and 0.8% in 2009. Total non-performing assets to total assets decreased to 0.6% in 2011 from 0.7% in 2010 and increased from 0.5% in 2009. Our allowance for loan losses to total non-performing assets increased to 119.3% in 2011 from 105.1% in 2010 and decreased from 155.7% in 2009. Additional detail can be found on page 31, Table 10 — Non-Performing Assets and page 61 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, and a full-time workout specialist to manage collection efforts.

Impaired loans were $4,188,000 at December 31, 2011. Three relationships carried aggregate balances of $450,000 or greater. The largest relationship is represented by two loans carrying a balance of $1,000,000 secured by commercial real estate and business assets. The year-end valuation carried a net realizable value of $804,000, after an estimated 10% cost to sell, resulting in a specific allocation of $196,000. The second largest relationship is represented by two loans carrying a balance of $586,000 secured by leasehold mortgages. The year-end valuations carried a net realizable value of $382,000, after an estimated 10% cost to sell, resulting in a specific allocation of $204,000 at December 31, 2011. The third largest relationship is represented by three loans carrying a balance of $457,000 secured by residential real estate and a bare land track. The year-end valuation carried a net realizable value of $298,000, after an estimated 10% cost to sell, resulting in a specific allocation of $159,000. Of the $4,188,000, $586,000 is located outside of our primary market area. None of the impaired loans were participation loans.

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 (the format was approved by the State Department of Banking and the FDIC examiners), 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 2012. As of December 31, 2011, the Corporation did not have any troubled debt restructurings in its loan portfolio. Excluding the assets disclosed 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 and lease 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 2011, 2010 and 2009 was $54,000, $63,000 and $61,000, respectively. Interest income, which would have been recorded on these loans under the original terms in 2011, 2010 and 2009 was $342,000, $316,000 and $242,000, respectively. At December 31, 2011 and 2010, 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, 2011 and 2010, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 10 — Non-Performing Assets

(Amounts in thousands)

	2011	2010	2009
Non-performing assets			
Impaired loans	$4,188	$4,276	$2,948
Foreclosed assets held for resale	780	1,149	330
Loans past-due 90 days or more and still accruing interest	—	—	140
Total non-performing assets	$4,968	$5,425	$3,418
Impaired loans			
Non-performing loans	$4,188	$4,276	$2,948
Allocated allowance for loan losses	(947)	(605)	(834)
Net investment in impaired loans	$3,241	$3,671	$2,114
Impaired loans with a valuation allowance	$2,556	$2,553	$1,055
Impaired loans without a valuation allowance	1,632	1,723	1,893
Total impaired loans	$4,188	$4,276	$2,948
Valuation allowance related to impaired loans	$947	$605	$834
Valuation allowance as a percent of impaired loans	22.6 %	14.2 %	28.3 %
Impaired loans to loans net of unearned discount	1.0 %	1.0 %	0.7 %
Non-performing assets to period-end loans and foreclosed assets	1.2 %	1.3 %	0.8 %
Total non-performing assets to total assets	0.6 %	0.7 %	0.5 %
Allowance for loan losses to impaired loans	141.6%	133.3%	180.5%
Allowance for loan losses to total non-performing assets	119.3%	105.1%	155.7%

Real estate mortgages comprise 88.7% of the loan portfolio as of December 31, 2011, as compared to 88.1% in 2010. 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 First Keystone’s subsidiary 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 along with prevailing market rates, especially when establishing interest rates on certificates of deposit.

Deposits decreased by $2,546,000, or a 0.4% for the year ending December 31, 2011. This decrease compares unfavorably to a deposit increase of $46,326,000, or 8.0% in 2010. In 2011, the Bank experienced a $6,409,000 or 9.3% increase in non-interest bearing deposits. However, the overall drop in deposits of $2,546,000 was due to lower volume of new retail certificates of deposit less than $100,000. Much of the deposit increase in 2010 related to the economy and the concerns on Wall Street. The Corporation believes customers sought the safety and stability of community banks, together with the increased FDIC insurance limits, which accounts for the rise in deposits during 2010.

The deposit growth in 2010 was not a function of First Keystone paying higher interest rates to spur deposit growth. In fact, the Bank's cost of interest bearing deposits fell in 2010 and its net-interest margin actually increased to 3.63% in 2010.

During 2011, the Corporation increased its reliance on borrowings. Short-term borrowings amounted to $30,882,000 as of year-end 2011, an increase of $9,905,000 from 2010. However, long-term borrowings decreased to $64,339,000 in 2011 as compared to $66,400,000 as of December 31, 2010. Total borrowings were $95,221,000 as of December 31, 2011, compared to $87,377,000 on December 31, 2010. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, U.S. Treasury demand notes, and short-term borrowings from the Federal Home Loan Bank ("FHLB"). Short-term borrowings from the FHLB are commonly used to offset seasonal fluctuations in deposits. Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more. In connection with FHLB borrowings, U.S. Treasury demand notes and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

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 $14,032,000 in 2011 after an increase of $4,893,000 in 2010. Approximately 66.9% of the increase in equity capital in 2011 related to an increase in accumulated other comprehensive income (loss) due to market fluctuations, while approximately 79.7% of the increase in equity capital in 2010 related to an increase in retained earnings. The accumulated other comprehensive income (loss) amounted to $7,757,000 in 2011 and $(1,633,000) in 2010. The Corporation had 242,517 shares of common stock as of December 31, 2011, and 243,540 shares of common stock as of December 31, 2010, at a cost of $6,069,000 and $6,103,000, respectively, as treasury stock.

Return on average equity ("ROE") is computed by dividing net income by average stockholders' equity. This ratio was 11.57% for 2011, 10.98% for 2010, and 10.88% for 2009. Refer to Performance Ratios on page 17 — 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 our Corporation and Bank. The Corporation's leverage ratio was 8.07% at December 31, 2011 and 7.44% at December 31, 2010.

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 69. 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, 2011		December 31, 2010	
	Corporation	Bank	Corporation	Bank
Risk-Based Capital:				
Tier I risk-based capital ratio	11.99%	12.57%	10.85%	11.52%
Total risk-based capital ratio (Tier 1 and Tier 2)	13.09%	13.64%	11.87%	12.53%
Leverage Ratio:				
Tier I capital to average assets	8.07 %	8.59 %	7.44 %	8.02 %

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 2011, cash and due from banks decreased to $10,179,000 from $11,905,000. 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.

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 Reserve Bank 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.

The following table represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of December 31, 2011.

(Amounts in thousands)

Contractual Obligations	Less than 1 Year	1 - 3 Years	3 -5 Years	Over 5 Years	Total

Time deposits	$135,711	$90,269	$ 26,151	$—	$252,131
Securities sold under agreement to repurchase	18,132	—	—	—	18,132
FHLB borrowings	28,750	32,750	13,000	2,000	76,500
Commitments to grant loans[1]	5,703	—	—	—	5,703
Commitments to fund loans for secondary market mortgages	1,311	—	—	—	1,311
Unfunded commitments on lines of credit[1]	47,445	—	—	—	47,445
Purchase obligations of loan participations[1]	8,000	—	—	—	8,000
Financial standby letters of credit[1]	789	—	—	—	789
Performance standby letters of credit[1]	4,370	—	—	—	4,370
Purchase and building commitments	6,080	—	—	—	6,080
Operating lease obligations	187	305	189	2,394	3,075
Capital lease obligations	108	406	290	—	804
	$256,586	$123,730	$ 39,630	$4,394	$424,340

[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.

MARKET RISK

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

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

Asset/Liability Management

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Table 12 presents an interest sensitivity analysis of assets and liabilities as of December 31, 2011. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 12 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (December 31, 2011 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive.

Table 12 — Interest Rate Sensitivity Analysis

(Amounts in thousands)

	December 31, 2011				
	One Year	1 - 5 Years	Beyond 5 Years	Not Rate Sensitive	Total
Assets	$185,827	$342,096	$239,585	$51,038	$818,546
Liabilities/Stockholders' Equity	207,178	333,509	182,444	95,415	818,546
Interest Rate Sensitivity Gap	$(21,351)	$8,587	$57,141	$(44,377)	
Cumulative Gap	$(21,351)	$(12,764)	$44,377		

Earnings at Risk

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

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

Earnings Simulation Modeling

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

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under an increase and decrease of 200 basis points in the interest rate earnings simulation model.

Table 13 presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from an increase or decrease of two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease by approximately 7.0% if rates fell by two percentage points over one year. The model projects a decrease of approximately 3.7% in net interest income if rates rise by two percentage points over one year. Both of these forecasts are within the Corporation's one year policy guidelines.

Net Present Value Estimation

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At year-end 2011, a 200 basis point immediate decrease in rates is not estimated to increase or decrease net present value. Additionally, net present value is projected to decrease by 3.0% if rates increase immediately by 200 basis points. Both scenario projections are below the Corporation's policy limits of 35%.

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

Table 13 — Effect of Change in Interest Rates

	Projected Change	
Effect on Net Interest Income		
1-year Net Income Simulation Projection		
-200 bp Shock vs Stable Rate	(7.0	)%
+200 bp Shock vs Stable Rate	(3.7	)%
Effect on Net Present Value of Balance Sheet		
Static Net Present Value Change		
-200 bp Shock vs Stable Rate	0.0	%
+200 bp Shock vs Stable Rate	(3.0	)%

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Table 14 — Quarterly Results of Operations (Unaudited)

(Amounts in thousands, except per share)

	Three Months Ended			
2011	March 31	June 30	September 30	December 31
Interest income	$9,347	$9,330	$ 9,237	$ 9,114
Interest expense	2,516	2,463	2,340	2,086
Net interest income	6,831	6,867	6,897	7,028
Provision for loan losses	300	300	500	800
Non-interest income	963	1,059	1,343	1,066
Non-interest expense	4,304	4,472	4,431	4,488
Income before income tax expense	3,190	3,154	3,309	2,806
Income tax expense	694	611	632	615
Net income	$2,496	$2,543	$ 2,677	$ 2,191
Per share	$.46	$.47	$ .49	$ .40

	Three Months Ended			
2010	March 31	June 30	September 30	December 31
Interest income	$9,433	$9,528	$ 9,585	$ 9,608
Interest expense	3,469	3,324	3,092	2,857
Net interest income	5,964	6,204	6,493	6,751
Provision for loan losses	200	400	1,075	900
Non-interest income	1,096	1,395	2,073	1,194
Non-interest expense	4,121	4,278	4,288	4,585
Income before income tax expense	2,739	2,921	3,203	2,460
Income tax expense	552	608	713	489
Net income	$2,187	$2,313	$ 2,490	$ 1,971
Per share	$.40	$.43	$ .45	$ .37

Critical Accounting Estimates

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation applies those accounting policies in a consistent manner.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require that the Corporation make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are based on historical and other factors believed to be reasonable under the circumstances. The Corporation evaluates these estimates and assumptions on an ongoing basis and may retain outside consultants, lawyers and actuaries to assist in its evaluation.

The Corporation believes the following accounting policies are the most critical because they involve the most significant judgments and estimates used in preparation of its consolidated financial statements. Please refer to the discussion of the allowance for loan losses calculation under “Non-Performing Assets” and the “Allowance for Loan Losses” in the “Financial Condition” section of Management’s Discussion and Analysis. Please refer to Note 1 to the consolidated financial statements for “Income Taxes” and “Goodwill, Intangible Assets and Premium Discounts”. Please refer to Note 3 to the consolidated financial statements for the discussion on estimating other-than-temporary impairment losses on securities. Please refer to Note 14 to the consolidated financial statements for “Commitments and Contingencies”. Please refer to Note 21 to the consolidated financial statements for “Fair Values of Financial Instruments”.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Information with respect to quantitative and qualitative disclosures about market risk is included in the information under Management’s Discussion and Analysis in Item 7 hereof.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

BOARD OF DIRECTORS AND STOCKHOLDERS OF FIRST KEYSTONE CORPORATION:

We have audited the accompanying consolidated balance sheets of First Keystone Corporation and Subsidiary as of December 31, 2011 and 2010 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. First Keystone Corporation's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Keystone Corporation and Subsidiary as of December 31, 2011 and 2010, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) First Keystone Corporation and Subsidiary's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 15, 2012, expressed an unqualified opinion.

/s/ J. H. Williams & Co., LLP
J. H. Williams & Co., LLP

Kingston, Pennsylvania

March 15, 2012

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	December 31,	
	2011	2010
ASSETS		
Cash and due from banks	$8,403	$4,346
Interest-bearing deposits in other banks	1,776	4,559
Federal funds sold	—	3,000
Total cash and cash equivalents	10,179	11,905
Investment securities available-for-sale	328,824	303,902
Investment securities held-to-maturity (estimated fair value 2011- $2,666; 2010 - $6,191)	2,605	6,266
Restricted securities at cost - available-for-sale	5,189	6,363
Loans, net of unearned income	415,995	409,651
Allowance for loan losses	(5,929)	(5,701)
Net loans	410,066	403,950
Premises and equipment, net	12,725	11,842
Accrued interest receivable	4,375	4,589
Cash surrender value of bank owned life insurance	19,145	18,388
Investment in limited partnerships	1,484	1,600
Goodwill	19,133	19,133
Core deposit intangible	951	1,240
Prepaid FDIC insurance	1,427	2,005
Foreclosed assets held for resale	780	1,149
Deferred income taxes	30	2,742
Other assets	1,633	1,527
TOTAL ASSETS	$818,546	$796,601
LIABILITIES		
Deposits:		
Non-interest bearing	$75,489	$69,080
Interest bearing	548,860	557,815
Total deposits	624,349	626,895
Short-term borrowings	30,882	20,977
Long-term borrowings	64,339	66,400
Accrued interest and other expenses	2,857	2,976
Deferred income taxes	2,350	—
Other liabilities	677	293
TOTAL LIABILITIES	$725,454	$717,541
STOCKHOLDERS' EQUITY		
Common stock, par value $2.00 per share; authorized 10,000,000 shares; issued 5,687,767 in 2011 and 2010	$11,375	$11,375
Surplus	30,157	30,175

Retained earnings	49,872	45,246
Accumulated other comprehensive income (loss)	7,757	(1,633)
Treasury stock, at cost, 242,517 shares in 2011 and 243,540 shares in 2010	(6,069)	(6,103)
TOTAL STOCKHOLDERS' EQUITY	93,092	79,060
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$818,546	$796,601

The accompanying notes are an integral part of these consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except per share data)	Year Ended December 31,		
	2011	2010	2009
INTEREST INCOME			
Interest and fees on loans	$23,369	$24,401	$24,819