FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 12, 2018
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2017

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 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1440803
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
20 South Main Street, Chambersburg, PA	17201-0819
(Address of principal executive offices)	(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

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 $1.00 per share

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not 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

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

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes No

The aggregate market value of the 4,050,683 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2017 based on the price of such shares was $129,621,856.

There were 4,364,433 outstanding shares of the Registrant's common stock as of February 28, 2018.

DOCUMENTS INCORPORATED BY REFERENCE

Article I. Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2017, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

FORM 10-K

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Part I

Item 1. Business

General

Franklin Financial Services Corporation (the "Corporation") was organized as a Pennsylvania business corporation on June 1, 1983 and is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the "BHCA"). On January 16, 1984, pursuant to a plan of reorganization approved by the shareholders of Farmers and Merchants Trust Company of Chambersburg ("F&M Trust" or "the Bank") and the appropriate regulatory agencies, the Corporation acquired all the shares of F&M Trust and issued its own shares to former F&M Trust shareholders on a share-for-share basis.

The Corporation's common stock is thinly traded in the over-the-counter market. The Corporation's stock is listed under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote) on the OTCQX Market Tier of the OTC Markets. The Corporation's internet address is www.franklinfin.com. Electronic copies of the Corporation's 2017 Annual Report on Form 10-K are available free of charge by visiting the "Investor Information" section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust, which is wholly owned. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-two community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. The Bank engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the "FDIC"). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Future Fund Inc., a direct subsidiary of the Corporation, is a non-bank investment company that makes venture capital investments, limited to 5% or less of the outstanding shares of any class of voting securities of any company, within the Corporation's primary market area. Franklin Financial Properties Corp. is a "qualified real estate subsidiary," a wholly owned subsidiary of F&M Trust, and was established to hold real estate assets used by F&M Trust in its banking operations.

F&M Trust is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Bank's business is seasonal. The Bank's lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans,

installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations.

The Bank classifies loans in this report by the type of collateral, primarily residential or commercial and agricultural real estate. Loans secured by residential real estate loans may be further broken down into consumer or commercial purposes. Consumer purpose residential real estate loans represent traditional residential mortgages and home equity products. Both of these products are underwritten in generally the same manner; however, home equity products may present greater risk since many of these loans are secured by a second lien position where the Bank may or may not hold the first lien position. Commercial purpose residential real estate loans represent loans made to businesses, but are secured by residential real estate. These loans are underwritten as commercial loans and the repayment ability may be dependent on the business operation, despite the residential collateral. In addition to the real estate collateral, it is possible that personal guarantees or UCC filings on business assets provide additional security. In certain situations, the Bank acquires properties through foreclosure on delinquent loans. The Bank initially records these properties at the estimated fair value less cost to sell with subsequent adjustments to fair value recorded as needed.

Commercial and agricultural real estate loans are secured by properties such as hotels, office buildings, apartment buildings, retail sites, and farmland or agricultural related properties. These loans are highly dependent on the business operations for repayment. Compared to residential real estate, this collateral may be more difficult to sell in the event of a delinquency.

Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings, and are secured by mortgages on real estate. These loans are primarily comprised of loans to consumers to build a home, and loans to contractors and developers to construct residential properties for resale or rental. Construction loans present various risks that include, but are not limited to: schedule delays, cost overruns, changes in economic conditions during the construction period, and the inability to sell or rent the property upon completion.

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for

repayment and are generally secured by business assets and personal guarantees. As such, this collateral may be more difficult to sell in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

Consumer loans are comprised of unsecured personal lines of credit and installment loans. While some of these loans are secured, the collateral behind the loans is often comprised of assets that lose value quickly (e.g. automobiles) and if repossessed, may not fully satisfy the loan in the event of default. Repayment of these loans is highly dependent on the borrowers' financial condition that can be affected by economic factors beyond their control and personal circumstances.

F&M Trust's Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with community bank trust departments including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and custodial services. F&M Trust through licensed members of its Investment and Trust Services Department sells mutual funds, annuities and selected insurance products.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are 24 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other on-line competitors compete within the market.

The following table shows the Bank's market share in its primary market as reported on the June 30, 2017 FDIC Summary of Deposits Report:

(Dollars in thousands)

	F&M Trust			
County	# of Locations	Deposits	Market Deposits	Market Share
Franklin	12	$ 687,688	$ 2,140,858	32%
Cumberland	7	230,960	6,775,750	3%

Fulton	2	73,119	209,071	35%
Huntingdon	1	15,906	605,093	3%
	22	$ 1,007,673	$ 9,730,772	10%

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have been flat and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors may have access to resources (e.g., financial and technological) sooner than they are available to the Bank, or that may be unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product, service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $1.2 billion on December 31, 2017.

Staff

As of December 31, 2017, the Corporation and its banking subsidiary had 255 full-time equivalent employees. The officers of the Corporation are employees of the Bank. The Bank offers a 401(k) plan, employee stock purchase plan and incentive compensation plans and employees are also provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

Various requirements and restrictions under the laws of the United States and under Pennsylvania law affect the Corporation and its subsidiaries.

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a "financial holding company." Financial holding companies are bank holding companies that meet certain minimum

capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis as further discussed below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its Bank subsidiary during periods of financial stress or adversity. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

The Bank Holding Company Act prohibits the Corporation from acquiring direct or indirect control of more than 5% of the outstanding shares of any class of voting stock, or substantially all of the assets of any bank, or from merging or consolidating with another bank holding company, without prior approval of the Federal Reserve Board. Additionally, the Bank Holding Company Act prohibits the Corporation from engaging in or from acquiring ownership or control of more than 5% of the outstanding shares of any class of voting stock of any company engaged in a non banking business, unless such business is determined by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto. Federal law and Pennsylvania law also require persons or entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking and Securities.

As a Pennsylvania bank holding company for purposes of the Pennsylvania Banking Code, the Corporation is also subject to regulation and examination by the Pennsylvania Department of Banking and Securities.

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank's primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking and Securities. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications.

Community Reinvestment Act

The Community Reinvestment Act (CRA) requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act, assigned by the FDIC pursuant to an examination of the Bank, is important in

determining whether the bank may receive approval for, or utilize certain streamlined procedures in applications to engage in new activities. The Bank's present CRA rating is "satisfactory." Various consumer laws and regulations also affect the operations of the Bank.

Capital Adequacy Guidelines

The Corporation, as a bank holding company, is required to comply with the capital adequacy standards established by Federal Reserve Board. The Bank is required to comply with capital adequacy standards established by the FDIC. In addition, the Pennsylvania Department of Banking and Securities also requires state chartered banks to maintain minimum capital ratios, defined substantially the same as the federal regulations.

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as "Basel III." The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered "well capitalized" under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3)Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer is phased-in beginning at 0.625% for 2016, 1.25% for 2017, 1.875% for 2018 and 2.50% for 2019 and thereafter. The capital conservation buffer is applicable to all of the capital ratios except for the Tier1 Leverage ratio. The capital conservation buffer is equal to the lowest value of the three applicable capital ratios less the regulatory minimum for each respective capital measurement. The Bank's capital conservation buffer at December 31, 2017 was 7.19% (total risk-based capital 15.19% less 8.00%) compared to the 2017 regulatory buffer of 1.25%. Compliance with the capital conservation buffer is required in order to avoid limitations on certain capital distributions, especially dividends. As of December 31, 2017, the Bank was "well capitalized' under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such requirements been in effect. The minimum capital ratios (shown as "adequately capitalized") and the "well capitalized" capital ratios are reported in Note 2 of the accompanying financial statements.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a "well capitalized" institution as "adequately capitalized" or require an "adequately capitalized" or "undercapitalized" institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2017, the Bank satisfied the criteria to be classified as "well capitalized" within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules and the Basel III rules, described above, may further limit the ability of banks to pay dividends or make capital distributions if regulatory capital requirements are not met. There are currently no restrictions on the payments of dividends by either the Bank or the Corporation.

Volker Rule

In December 2013, Federal banking regulators issued rules for complying with the Volker Rule provision of the Dodd-Frank Act. The Bank does not engage in, or expect to engage in, any transactions that are considered “covered activities” as defined by the Volker Rule. Therefore, the Bank does not have any compliance obligations under the Volker Rule.

Consumer Laws and Regulations

The Consumer Financial Protection Bureau (“CFPB”) was created under the Dodd-Frank Act to centralize responsibility for consumer financial protection with broad rulemaking, supervision, and enforcement authority for a wide range of

consumer protection laws that would apply to all banks and thrifts, including the Equal Credit Opportunity Act, Truth in Lending Act ("TILA"), Real Estate Settlement Procedures Act ("RESPA"), Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statues. Violations of consumer protection laws may result in litigation and liability from consumers and regulators. It is likely that future CFPB rulemaking action will affect the Bank. Banks with total assets less than $10 billion are not subject to examination by the CFPB. However, the CFPB can require any bank to submit reports it deems necessary to fulfill its mission and it can request to be part of any bank examination.

Ability to Repay / Qualified Mortgages

In July 2013, the Consumer Finance Protection Bureau adopted the final rules that implement the Ability to Repay (ATR) / Qualified Mortgages (QM) provisions of the Dodd-Frank Act. Regulators believe that the ATR/QM rules will prevent many of the loose underwriting practices that contributed to the mortgage crisis in 2008. The ATR/QM rule applies to almost all closed-end consumer credit transactions secured by a dwelling. The ATR rule provides eight specific factors that must be considered during the underwriting process. QMs generally have three types of requirements: restrictions on loan features, points and fees, and underwriting criteria. A QM is presumed to comply with the ATR requirements. The ATR/QM rule was effective January 10, 2014.

Commercial Real Estate Guidance

In December 2015, the federal banking agencies released a "Statement on Prudent Risk Management for Commercial Real Estate Lending" (the "CRE Statement"). The agencies stated that financial institutions should review their policies and practices related to CRE lending and should maintain risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk, including maintaining underwriting discipline and exercising prudent risk management practices that identify, measure, monitor and manage the risks arising from their CRE lending activity. Financial institutions were directed to review the interagency guidance on "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" issued in 2006 providing that a financial institution is potentially exposed to significant CRE concentration risk, and should employ enhanced risk management practices where (1) total CRE loans represent 300% or more of total capital, and (2) the outstanding balance the CRE loan portfolio has increased by 50% or more during the prior 36 months. The agencies state in the CRE statement that they will focus on those financial institutions that have recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity, or that operate in markets or loan segments with increasing growth or risk fundamentals.

Pennsylvania Regulation and Supervision

In December 2012, the “Banking Law Modernization Package” became effective. The law permits banks to disclose formal enforcement actions initiated by the Pennsylvania Department of Banking and Securities, clarifies that the Department has examination and enforcement authority over subsidiaries as well as affiliates of regulated banks, and bolsters the Department’s enforcement authority over its regulated institutions by clarifying its ability to remove directors, officers and employees from institutions for violations of laws or orders or for any unsafe or unsound practice or breach of fiduciary duty. The Department also may assess civil money penalties of up to $25,000 per violation.

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of $250,000 for each separately insured depositor. The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2017, the Bank was considered well capitalized and its assessment rate was approximately 3 basis points of the assessment base.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (“FICO”) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2019. The Bank’s FICO assessment was approximately $52 thousand in 2017 and was included in FDIC insurance expense.

New Legislation

Congress is often considering new financial industry legislation, and the federal banking agencies routinely propose new regulations. The Corporation cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

Tax Reform

On December 22, 2017 the Tax Cuts and Jobs Act (the Act) was signed into law. This comprehensive tax legislation provides for significant changes to the U.S. Internal Revenue Code of 1986, as amended, that impact corporate taxation such as the reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. The Act repeals the corporate alternative minimum tax, provides for earlier recognition of certain revenue, accelerates expensing of investments in tangible property and limits several deductions such as FDIC premiums, certain executive compensation and meals and entertainment expenses. We are currently assessing the overall impact of the Act on the future expected federal income tax obligations of the Corporation and our customers. While we expect that our future federal income tax liabilities will benefit overall from the provisions in the Act, we also expect that certain aspects of our business may change over time as to the investments we may make, how the Act may affect our customers, and how, in response, we may offer and deliver our products and services.

Selected Statistical Information

Certain statistical information is included in this report as part of Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 1A. Risk Factors

The following is a summary of the primary risks associated with the Corporation's business, financial condition and results of operations, and common stock.

Risk Factors Relating to the Corporation

Real estate related loans are a significant portion of our loan portfolio.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2017, approximately 68% ($647.1 million) of its loans

were secured by real estate. Loans secured by real estate and the percent of the loan portfolio are reported in Table 16. These real estate loans are located primarily in the Bank's market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. If a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. Localized events such as plant closures or layoffs may affect real estate prices and collateral values and could have a more negative affect on the Bank as compared to other competitors with a more geographically diverse portfolio. As the Bank grows, it is expected that real estate secured loans will continue to comprise a significant part of its balance sheet. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

Commercial loans are a significant portion of our loan portfolio.

The Bank continues to grow its commercial loan portfolio. Commercial purpose loans account for 84% ($795 million) of the total loan portfolio. These loans are made to businesses for a variety of commercial purposes and may include fixed and variable rate loans, term loans, and lines of credit. Commercial purpose loans may be secured by real estate, business assets and equipment, personal guarantees, or non-real estate collateral. Commercial purpose loans secured by real estate were $469.1 million at December 31, 2017 and account for 63% of the total commercial loan portfolio. These loans contain all the risks associated with real estate lending as discussed above. In addition, commercial real estate collateral may be more difficult to liquidate for repayment purposes than residential real estate. The repayment of commercial loans is highly dependent upon the success of the business activity and as such maybe more susceptible to risk of loss during a downturn in the economy. Because the Bank's commercial loan portfolio is concentrated in south-central Pennsylvania, the ability to repay these loans could be affected by deterioration of the economy in this region. As commercial lending continues to be the primary drive of loan growth, these new loans may present additional risk due to a lack of repayment history with the Bank. The Bank attempts to mitigate these risks through its underwriting and loan review process; however, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

The allowance for loan losses may prove to be insufficient to absorb inherent losses in our loan portfolio.

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any inherent losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan.

Although Management believes the loan loss allowance is adequate to absorb inherent losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excessive loan losses could have a material adverse effect on the Bank's financial condition and results of operations.

The Bank's lending limit is smaller than many of our competitors, which affects the size of the loans it can offer customers.

The Bank's lending limit is approximately $18.5 million. Accordingly, the size of the loans that can be offered to customers is less than the size of loans that many of our competitors, with larger lending limits, can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank's primary market areas and its geographic diversification is limited.

The Bank encounters strong competition from other financial institutions in its primary market area, which consists of Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. In addition, established financial institutions not already operating in the Bank's primary market area may open branches there at future dates or can compete in the market via the Internet. In the conduct of certain aspects of banking business, the Bank also competes with savings institutions, credit unions, mortgage banking companies, consumer finance companies, insurance companies and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon the Bank. Many of these competitors have substantially greater resources and lending limits and can offer services that the Bank does not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse effect on the Bank's financial condition and results of operations.

Changes in interest rates could have an adverse impact upon our results of operations.

The Bank's profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Interest rates are highly sensitive to many factors that are beyond the Bank'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, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank's ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank's net interest income, and therefore earnings, could be adversely affected. Likewise, the Bank currently has a very low cost of funds that it may be unable to maintain in a raising rate environment. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk

Our operational or security systems may experience interruption or breach in security, including cyber-attacks.

We rely heavily on communications and information systems to conduct our business. These systems include both our internal network and data systems, as well as those of third party vendors. Any failure, interruption or breach in security or these systems, including a cyber-attack, could result in the disclosure or misuse of confidential or proprietary information. Cyber security risks for financial institutions have significantly increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties, including foreign state actors. Financial services institutions have been subject to, and are likely to continue to be the target of, cyber-attacks, including computer viruses, malicious or destructive code, phishing attacks, denial of service or information or other security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of confidential, proprietary and other information of the institution, its employees or customers or of third parties, or otherwise materially disrupt network access or business operations. Cyber threats could result in unauthorized access, loss or destruction of customer data, unavailability, degradation or denial of service, introduction of computer viruses and other adverse events, causing the Corporation to incur additional costs (such as repairing systems or adding new personnel or protection technologies). Cyber threats may also subject the Corporation to regulatory investigations, litigation or enforcement, require the payment of regulatory fines or penalties or undertaking costly remediation efforts. While we have systems, policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of client business, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

A large component of fee income is dependent on stock market values.

Fee income from the Bank's Investment and Trust Services Department comprises a large percentage of total noninterest income. Fee income from Investment and Trust Services is comprised primarily of asset management fees as measured by the market value of assets under management. As such, the market values are directly related to stock market values. Therefore, any significant change in the value of assets under management due to stock market fluctuations could greatly affect fee income.

A large component of fee income is dependent on two deposit services.

Fee income from the Bank's debit card is a significant contributor of fee income. As technology changes and consumer payment preferences change it is possible that debit card income does not continue to grow or may decline. The Bank's overdraft protection program has also been a significant contributor of fee income. It is possible that the usage of this product slows or that regulatory changes effect the fees that can be charged for such services.

A large percentage of certificates of deposit have short-term maturities.

Sixty-five percent ($49.3 million) of the Bank's certificates of deposit are scheduled to mature within one year. If the Bank is unable to retain these deposits, it may require the Bank to access other sources of liquidity that may carry a higher cost.

Liquidity contingency funding is highly concentrated.

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB). Access to funding through the FHLB is the largest component of the Bank's liquidity stress testing and contingency funding plans. The ability to access funding from FHLB may be critical if a funding need arises. However, there can be no assurance that the FHLB will be able to provide funding when needed, nor can there be assurance that the FHLB will provide funds to the Bank if its financial condition deteriorates. The inability to access

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FHLB funding, through a restriction on credit or the failure of the FHLB, could have a materially adverse effect on the Bank’s liquidity management.

Our business and financial results could be impacted materially by adverse results in legal proceedings.

The nature of the Corporation’s business generates a certain amount of litigation involving matters arising in the ordinary course of business (and, in some cases, from the activities of companies we have acquired). These legal proceedings, whether founded or unfounded, could result in reputation damage and have an adverse effect on our financial condition and results of operation if they are not resolved in a manner favorable to the Corporation. Although we establish legal accruals for legal proceedings when information related to the loss contingencies represented by these matters indicates that both a loss is probable and that the amount of the loss can be reasonably estimated, we do not have accruals for all legal proceedings where we face a risk of loss. In addition, due to the inherent subjectivity of the assessments and unpredictability of outcomes of legal proceedings, any amounts that may be accrued or included in estimates of possible losses or ranges of possible losses may not represent the actual loss to the Corporation. We discuss these matters further in Part I Item 3 Legal Proceedings and in Note 18 Commitments and Contingencies in the Notes to Consolidated Financial Statements in Part II Item 8 of this Report.

Risk Factors Relating to the Common Stock

There is a limited trading market for the Corporation’s common stock.

There is currently only a limited public market for the Corporation’s common stock. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol “FRAF” (www.otcmarkets.com/stock/FRAF/quote). Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares.

The Bank's ability to pay dividends to the Corporation is subject to regulatory limitations that may affect the Corporation’s ability to pay dividends to its shareholders.

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank's cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible;

depending upon the Bank's financial condition and other factors, that the Bank's regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Corporation's headquarters is located in the main office of F&M Trust at 20 South Main Street, Chambersburg, Pennsylvania. This location also houses a community banking office as well as operational support services for the Bank. The Corporation owns or leases thirty-seven properties in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, for banking operations, as described below:

Property	Owned	Leased
Community Banking Facilities	16	6
Remote ATM Sites	3	7
Other Properties	3	2

Included in Other Properties are two properties used for operational support services for the Bank, a drive-up location, one office that was closed as part of a branch consolidation in January 2015 and one other property leased for future use. The office closed in 2015 and was sold on February 28, 2018.

Item 3. Legal Proceedings

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business including, without limitation, the Kalan et al. v. Farmers and Merchants Trust Company of Chambersburg, et al. (Case No. 2:15-CV-01435-WB) case filed in the United States District Court for the Eastern District of Pennsylvania and described in our current reports on Form 8-K filed July 29, 2016, July 28, 2017, November 3, 2017 and January 2, 2018.

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The Kalan case was brought by the named plaintiffs as a putative class action on behalf of certain employee health and welfare benefit plans whose assets are held by trusts known as the Regional Employers Assurance League Voluntary Employee's Beneficiary Association and the Single Employer Welfare Benefit Plan, and the participants and beneficiaries of those plans. The plaintiffs allege that F&M Trust, as successor by merger to Community Trust Company, which F&M Trust acquired in 2008, and in its own capacity, served as trustee of the trusts and failed to perform its fiduciary duties in accordance with the prudent man standard of care, knowingly participated in and facilitated misconduct by its co-fiduciaries, and failed to take reasonable steps to prevent or remedy any fiduciary breaches of its co-fiduciaries. The plaintiffs purport to state claims against F&M Trust under the Employee Retirement Income Security Act (ERISA), the Racketeer Influenced and Corrupt Organizations Act (RICO), common law breach of fiduciary duties, and equitable restitution and disgorgement, and seek recovery of damages allegedly totaling at least $40 million, along with reasonable attorney's fees and other relief. F&M Trust denies any and all wrongdoing and liability and has vigorously defended against the plaintiffs' claims.

As described in our current report on Form 8-K filed January 2, 2018, F&M Trust entered into a Class Action Settlement Term Sheet on December 29, 2017 with the named plaintiffs and certain of the other remaining defendants in the Kalan case following a mediation of the case held pursuant to a stipulation for selection of a Mediator submitted jointly by the parties and approved by the Court. The Term Sheet provides for F&M Trust to make a settlement payment of $10 million in full and final settlement of all claims that the named plaintiffs and members of the Settlement Class (as defined by the Term Sheet) have brought or could have brought against F&M Trust. The Term Sheet further provides that the parties will enter into a definitive settlement agreement that is to provide for a general release of all claims by all parties to the case. The terms of the settlement will be subject to preliminary and final approval by the court.

The Corporation has accrued the $10 million settlement payment as an expense for the year ended December 31, 2017.

In management's opinion, there are no other proceedings pending to which the Corporation is a party or to which its property is subject which, if determined adversely to the Corporation, would be material. No material proceedings are pending or are known to be threatened or contemplated against us by any governmental authorities.

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

Market and Dividend Information

The Corporation's common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote). The range of high and low prices is shown in the following table for the years 2017 and 2016, as well as cash dividends declared for those periods. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2017 was $37.36. The Corporation had 1,756 shareholders of record as of December 31, 2017.

	Market and Dividend Information					
	2017			2016		
			Dividends			Dividends
(Dollars per share)	High	Low	Declared	High	Low	Declared
First quarter	$ 31.00	$ 28.60	$ 0.21	$ 23.50	$ 20.11	$ 0.19
Second quarter	33.00	30.10	0.24	24.00	21.62	0.21
Third quarter	35.25	31.25	0.24	24.60	23.35	0.21
Fourth quarter	38.50	34.95	0.24	29.00	24.35	0.21
			$ 0.93			$ 0.82

Restrictions on the Payment of Dividends

For limitations on the Corporation's ability to pay dividends, see "Supervision and Regulation – Regulatory Restrictions on Dividends" in Item 1 above.

Securities Authorized for Issuance under Equity Compensation Plans

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading "Executive Compensation – Compensation Tables" in the Corporation's Proxy Statement for the 2018 Annual Meeting of Shareholders.

Common Stock Repurchases

The Board of Directors, from time to time, authorizes the repurchase of the Corporation's $1.00 par value common stock. The repurchased shares will be held as Treasury shares available for issuance in connection with future stock dividends and stock splits, employee benefit plans, executive compensation plans, the Dividend Reinvestment Plan and other appropriate corporate purposes.

The following table shows stock repurchase activity under approved plans:

Plan Date	Authorized	Expiration	Shares Repurchased 2017	2016
4/18/2016	$350,000 in shares per calendar quarter	3/31/2017	-	34,048
10/12/2017	100,000 shares	9/30/2018	-	N/A

Performance Graph

The following graph compares the cumulative total return to shareholders of Franklin Financial with selected market indices and a bank peer group, consisting of Mid-Atlantic Banks with assets between $1 billion - $2 billion as of September 30, 2017; for the five year period ended December 31, 2017, in each case assuming an initial investment of $100 on December 31, 2012 and the reinvestment of all dividends. Information is provided by S&P Global Market Intelligence.

	Period Ending					
Index	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Franklin Financial Services Corporation	$ 100.00	$ 127.44	$ 169.89	$ 187.25	$ 235.97	$ 317.11
NASDAQ Composite	$ 100.00	$ 140.12	$ 160.78	$ 171.97	$ 187.22	$ 242.71
SNL Mid-Atlantic Bank Index	$ 100.00	$ 134.79	$ 146.85	$ 152.36	$ 193.66	$ 237.34
Peer Group	$ 100.00	$ 130.44	$ 136.13	$ 143.28	$ 184.81	$ 214.62

Shareholders' Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program whereby shareholders of the Corporation's common stock may reinvest their dividend, or make optional cash payment, to purchase additional shares of the Corporation. Beneficial owners of shares of the Corporation's common stock may participate in the program by making appropriate arrangements through their bank, broker or other nominee. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

Franklin Financial Services Corporation offers a dividend direct deposit program whereby shareholders of the Corporation's common stock may choose to have their dividends deposited directly into the bank account of their choice on the dividend payment date. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Annual Meeting:

The Annual Shareholders' Meeting will be held on Tuesday, April 24, 2018, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, PA. The Business Meeting will begin at 9:00 a.m. with breakfast provided prior to the meeting.

Websites:

Franklin Financial Services Corporation: www.franklinfin.com

Farmers & Merchants Trust Company: www.fmtrustonline.com

Stock Information:

The Corporation's common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote).

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is: Computershare
P.O. Box 30170
College Station, TX 77842-3170
1-800-368-5948

Item 6. Selected Financial Data

	Summary of Selected Financial Data as of and for the Year Ended December 31				
	2017	2016	2015	2014	2013
(Dollars in thousands, except per share)					
Balance Sheet Highlights					
Total assets	$ 1,179,813	$ 1,127,443	$ 1,035,295	$ 1,001,448	$ 984,587
Investment securities	127,336	143,875	159,473	171,751	159,674
Loans, net	931,908	882,798	771,930	717,420	713,711
Deposits	1,047,181	982,120	918,512	881,181	845,724
Shareholders' equity	115,144	116,493	111,376	103,521	95,388
Summary of Operations					
Interest income	$ 39,885	$ 36,979	$ 34,615	$ 34,794	$ 36,042
Interest expense	2,491	2,245	2,371	3,180	4,378
Net interest income	37,394	34,734	32,244	31,614	31,664
Provision for loan losses	670	3,775	1,285	764	2,920
Net interest income after provision for loan losses	36,724	30,959	30,959	30,850	28,744
Noninterest income	12,189	11,605	12,652	11,131	10,033
Noninterest expense	43,172	33,175	31,136	31,573	31,250
Income before income taxes	5,741	9,389	12,475	10,408	7,527
Federal income tax expense	3,565	1,302	2,271	2,006	1,295
Net income	$ 2,176	$ 8,087	$ 10,204	$ 8,402	$ 6,232
Performance Measurements					
Return on average assets	0.19%	0.74%	1.00%	0.83%	0.61%
Return on average equity	1.80%	7.04%	9.52%	8.44%	6.75%
Return on average tangible assets (1)	0.19%	0.75%	1.02%	0.87%	0.64%
Return on average tangible equity (1)	1.94%	7.64%	10.52%	9.72%	7.86%
Efficiency ratio (1)	82.59%	68.26%	67.39%	71.01%	72.11%
Net interest margin, fully tax equivalent	3.72%	3.62%	3.59%	3.56%	3.47%
Shareholders' Value (per common share)					
Diluted earnings per share	$ 0.50	$ 1.88	$ 2.40	$ 2.00	$ 1.51
Basic earnings per share	0.50	1.88	2.40	2.10	1.51
Regular cash dividends paid	0.93	0.82	0.74	0.68	0.68
Book value	26.44	26.99	26.05	24.54	22.88
Tangible book value (1)	24.37	24.90	23.94	22.36	20.55
Market value	37.36	28.60	23.50	22.00	17.10
Market value/book value ratio	141.30%	105.97%	90.21%	89.65%	74.74%
Price/earnings multiple	74.72	15.21	9.79	11.00	11.32
Current dividend yield*	2.49%	2.94%	3.23%	3.09%	3.98%
Dividend payout ratio	185.25%	43.56%	30.76%	33.88%	45.09%

Safety and Soundness					
Risk-based capital ratio (Total)	15.31%	15.67%	16.03%	15.49%	14.24%
Leverage ratio (Tier 1)	9.73%	10.11%	10.38%	9.69%	9.14%
Common equity ratio (Tier 1)	14.06%	14.41%	14.77%	0.00%	0.00%
Nonperforming loans/gross loans	0.28%	0.61%	0.73%	1.74%	3.49%
Nonperforming assets/total assets	0.45%	0.92%	1.18%	1.63%	3.04%
Allowance for loan loss/loans	1.25%	1.24%	1.29%	1.25%	1.34%
Net (recoveries) loans charged-off/average loans	-0.01%	0.33%	0.04%	0.19%	49.00%
Assets under Management					
Trust and Investment Services (fair value)	$ 686,941	$ 622,630	$ 586,664	$ 605,796	$ 574,680
Held at third-party brokers (fair value)	158,145	142,676	122,010	132,700	130,000

*Annualized
(1) See the section titled "GAAP versus Non-GAAP Presentation" that follows.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Application of Critical Accounting Policies:

Disclosure of the Corporation's significant accounting policies is included in Note 1 to the consolidated financial statements. These policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Senior management has discussed the development of such estimates, and related Management Discussion and Analysis disclosure, with the Audit Committee of the Board of Directors.

The following accounting policies are identified by management to be critical to the results of operations: Allowance for Loan Losses, Goodwill, Federal Income Taxes and Other-Than-Temporary-Impairment.

GAAP versus non-GAAP Presentations – The Corporation supplements its traditional GAAP measurements with certain non-GAAP measurements to evaluate its performance and to eliminate the effect of intangible assets. By eliminating intangible assets, the Corporation believes it presents a measurement that is comparable to companies that have no intangible assets or to companies that have eliminated intangible assets in similar calculations. However, not all companies may use the same calculation method for each measurement. The Efficiency Ratio measures the cost to generate one dollar of revenue. The non-GAAP measurements are not intended to be used as a substitute for the related GAAP measurements. The following table shows the calculation of the non-GAAP measurements.

(Dollars in thousands, except per share)	For the Year Ended December 31				
	2017	2016	2015	2014	2013
Return on Average Tangible Assets (non-GAAP)					
Net income	$ 2,176	$ 8,087	$ 10,204	$ 8,402	$ 6,232
Plus intangible amortization (net of tax)	—	—	119	341	281
Net income (non-GAAP)	—	—	10,323	8,743	6,513
Average assets	1,139,703	1,088,047	1,021,275	1,015,995	1,029,895
Less average intangible assets	(9,016)	(9,016)	(9,066)	(9,516)	(9,937)
Average assets (non-GAAP)	1,130,687	1,079,031	1,012,209	1,006,479	1,019,958
Return on average tangible assets (non-GAAP)	0.19%	0.75%	1.02%	0.87%	0.64%

Return on Average Tangible Equity (non-GAAP)					
Net income	$ 2,176	$ 8,087	$ 10,204	$ 8,402	$ 6,232
Plus intangible amortization (net of tax)	—	—	119	341	281
Net income (non-GAAP)	—	—	10,323	8,743	6,513
Average shareholders' equity	120,993	114,884	107,175	99,512	92,786
Less average intangible assets	(9,016)	(9,016)	(9,066)	(9,516)	(9,937)
Average shareholders' equity (non-GAAP)	111,977	105,868	98,109	89,996	82,849
Return on average tangible equity (non-GAAP)	1.94%	7.64%	10.52%	9.72%	7.86%
Tangible Book Value (per share) (non-GAAP)					
Shareholders' equity	$ 115,144	$ 116,493	$ 111,376	$ 103,521	$ 95,388
Less intangible assets	(9,016)	(9,016)	(9,016)	(9,197)	(9,714)
Shareholders' equity (non-GAAP)	106,128	107,477	102,360	94,324	85,674
Shares outstanding (in thousands)	4,355	4,317	4,276	4,218	4,169
Tangible book value (non-GAAP)	24.37	24.90	23.94	22.36	20.55
Efficiency Ratio (non-GAAP)					
Noninterest expense	$ 43,172	$ 33,175	$ 31,136	$ 31,573	$ 31,250
Net interest income	37,394	34,734	32,244	31,614	31,664
Plus tax equivalent adjustment to net interest income	2,690	2,246	2,203	1,978	1,596
Plus noninterest income, net of securities gains/losses & OTTI	12,186	11,623	11,756	10,871	10,075
Total revenue	52,270	48,603	46,203	44,463	43,335
Efficiency ratio (non-GAAP)	82.59%	68.26%	67.39%	71.01%	72.11%

Results of Operations:

Management's Overview

The following discussion and analysis is intended 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 presented elsewhere herein.

Highlights of 2017 performance include:

Net income was $2.2 million for the year, down 73.1% from $8.1 million in 2017.

- Net interest income increased $2.7 million and the net interest margin increased to 3.72%.
- The provision for loan loss expense decreased $3.1 million as credit quality continued to improve.
- Noninterest income increased by 5% driven by an increase in fees from Investment and Trust services.
- Noninterest expense increased by $10 million, solely the result of a $10 million reserve for a legal settlement.
- Federal income tax expense included a charge of $2.3 million for the revaluation of net deferred tax assets.

The balance sheet grew by more than $52.4 million, closing the year at $1.2 billion.

- Loans grew by 5.6% to $943.7 million.
- Deposits increased by $65.1 million to $1.0 billion.

Other key performance measurements are presented in Item 6, of this report.

A more detailed discussion of the areas that had the greatest effect on the reported results follows.

Net Interest Income

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, short-term borrowings and

long-term debt are the principal categories of interest-bearing liabilities. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2017 versus 2016

As shown on Table 1, tax equivalent net interest income increased 8.4% in 2017. This increase of $3.1 million was driven by a $2.9 million increase in tax equivalent interest income. A larger balance sheet contributed $2.6 million of the increase in tax equivalent interest income while the effect of rate changes added $739 thousand. The yield on earning assets (Table 3) improved from 3.84% for 2016 to 3.96% for 2017, driven by an increase in the yield on the loan portfolio. The yield on most earning assets benefited from three rate increases by the Federal Reserve during 2017. Interest expense increased $246 thousand, approximately 11%, over 2016. Rate changes on deposits were the primary contributor to the increase in interest expense. Most of the increase in interest expense occurred in the Money Management product. Table 2 shows the affect volume and rate had on the change in tax equivalent net interest income in 2017.

2016 versus 2015

Tax equivalent net interest income increased 7.9% in 2016. This increase was driven by a 6.8% increase in interest income. The yield on earning assets (Table 3) remained unchanged year-over-year at 3.84%. The yield on most earning asset classes declined in 2016, except for the yield on interest bearing deposits which was boosted by short-term bank owned CDs. Despite no change in the yield, average interest-earning assets increased $66.9 million over the 2015 average. The commercial loan portfolio was the growth leader in 2016 increasing more than $87 million in 2016. Even though the Federal Reserve increased short-term interest rates in December 2015, portfolio yields declined in 2016. However, a larger earning asset base more than offset the lower yields and improved interest income by $2.7 million (Table 2).

Interest expense declined slightly in 2016 and the cost of interest-bearing deposits fell by .03% from 2015. The cost of interest-bearing liabilities declined due to higher rate CDs maturing and an interest rate swap that matured in 2015 that pushed the cost of the money management product over the nominal rate. Table 2 shows the affect volume and rate had on the change in tax equivalent net interest income in 2016.

Table 1. Net Interest Income

(Dollars in thousands)	2017	Change $	%	2016	Change $	%	2015
Interest income	$ 39,885	$ 2,906	7.9	$ 36,979	$ 2,364	6.8	$ 34,615
Interest expense	2,491	246	11.0	2,245	(126)	(5.3)	2,371
Net interest income	37,394	2,660	7.7	34,734	2,490	7.7	32,244
Tax equivalent adjustment	2,690	444		2,246	223		2,023
Tax equivalent net interest income	$ 40,084	$ 3,104	8.4	$ 36,980	$ 2,713	7.9	$ 34,267

Table 2 identifies increases and decreases in tax equivalent net interest income to either changes in average volume or to changes in average rates for interest-earning assets and interest-bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to both. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

Table 2. Rate-Volume Analysis of Tax Equivalent Net Interest Income

	2017 Compared to 2016			2016 Compared to 2015		
Increase (Decrease) due to:	Increase (Decrease) due to:			Increase (Decrease) due to:		
(Dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	$ —	$ 114	$ 114	$ (44)	$ 84	$ 40
Investment securities:						
Taxable	(310)	110	(200)	(260)	66	(194)
Nontaxable	(299)	(137)	(436)	(146)	(146)	(292)
Loans:						
Commercial, industrial and agriculture	3,310	456	3,766	3,612	(413)	3,199
Residential mortgage	(105)	2	(103)	(134)	(54)	(188)
Home equity loans and lines	22	185	207	259	(97)	162
Consumer	(7)	9	2	(78)	(62)	(140)
Loans	3,220	652	3,872	3,659	(626)	3,033
Total net change in interest income	2,611	739	3,350	3,209	(622)	2,587

Interest expense on:

Interest-bearing checking	28	15	43	37	27	64
Money management	73	99	172	44	(144)	(100)
Savings	5	67	72	5	2	7
Time deposits	(39)	15	(24)	(73)	(53)	(126)
Short-term borrowings	(26)	8	(17)	25	4	29
Total net change in interest expense	41	204	246	38	(164)	(126)
Change in tax equivalent net interest income	$ 2,570	$ 535	$ 3,104	$ 3,171	$ (458)	$ 2,713

The following table presents average balances, tax-equivalent (T/E) interest income and expense, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

Table 3. Analysis of Net Interest Income

	2017			2016			2015		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Av yi
Interest-earning assets:									
Interest-bearing obligations of other banks and federal funds sold	$ 30,818	$ 401	1.30%	$ 30,833	$ 287	0.93%	$ 36,732	$ 247	0.
Investment securities:									
Taxable	92,031	2,088	2.27%	105,862	2,288	2.16%	117,973	2,482	2.
Tax Exempt	43,818	1,682	3.84%	51,429	2,118	4.12%	54,854	2,410	4.
Investments	135,849	3,770	2.78%	157,291	4,406	2.80%	172,827	4,892	2.
Loans:									
Commercial, industrial and agricultural	757,969	31,880	4.21%	679,114	28,114	4.14%	592,010	24,915	4.
Residential mortgage	74,697	2,979	3.99%	77,331	3,082	3.99%	80,679	3,270	4.
Home equity loans and lines	72,158	3,290	4.56%	71,660	3,083	4.30%	65,687	2,921	4.
Consumer	4,718	255	5.40%	4,841	253	5.23%	6,196	393	6.
Loans	909,542	38,404	4.22%	832,946	34,532	4.15%	744,572	31,499	4.
Total interest-earning assets	1,076,209	$ 42,575	3.96%	1,021,070	$ 39,225	3.84%	954,131	$ 36,638	3.
Other assets	63,494			66,977			67,144		
Total assets	$ 1,139,703			$ 1,088,047			$ 1,021,275		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing checking	$ 271,513	$ 363	0.13%	$ 250,562	$ 320	0.13%	$ 220,314	$ 256	0.
Money Management	416,926	1,535	0.37%	396,267	1,363	0.34%	384,499	1,463	0.
Savings	78,310	128	0.16%	72,724	56	0.08%	66,134	49	0.

Time	73,947	449	0.61%	80,391	473	0.59%	92,212	599	0.6
Total interest-bearing deposits	840,696	2,475	0.29%	799,944	2,212	0.28%	763,159	2,367	0.
Securities sold under agreements to repurchase	—	—	—	—	—	—	25	—	0.
Other borrowings	1,894	16	0.83%	5,258	33	0.63%	923	4	0.
Total interest-bearing liabilities	842,590	2,491	0.30%	805,202	2,245	0.28%	764,082	2,371	0.
Noninterest-bearing deposits	170,649			163,258			143,374		
Other liabilities	5,471			4,703			6,619		
Shareholders' equity	120,993			114,884			107,175		
Total liabilities and shareholders' equity	$ 1,139,703			$ 1,088,047			$ 1,021,250		
T/E net interest income/Net interest margin		40,084	3.72%		36,980	3.62%		34,267	3.
Tax equivalent adjustment		(2,690)			(2,246)			(2,023)	
Net interest income		$ 37,394			$ 34,734			$ 32,244	

Provision for Loan Losses

The Bank charged-off loans of $137 thousand in 2017, while recording recoveries of previously charged-off loans of $184 thousand. As a result, the Bank ended the year in a net recovery position of $47 thousand. This compares to $2.8 million in net-charge-offs in 2016. The 2016 charged-offs were inflated by one commercial real estate loan charge-off of $2.7 million. Without this charge-off, net charge-offs for 2016 would have been only $21 thousand. For 2017, the provision for loan loss expense was $670 thousand and was added to the allowance for loan losses (ALL) primarily as the result of loan growth. The ALL was $11.8 million at year-end 2017 (1.25% of total loans), compared to $11.1 million at year-end 2016 (1.24% of total loans). Management closely monitors the credit quality of the portfolio in order to ensure that an appropriate ALL is maintained. As part of this process, Management performs a comprehensive analysis of the loan portfolio considering delinquencies trends and events, current economic conditions, and other relevant factors to determine the adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Loan Quality discussion and Tables 11 - 17.

Noninterest Income

The following table presents a comparison of noninterest income for the years ended December 31, 2017 and 2016:

Table 4. Noninterest Income

(Dollars in thousands)	2017	2016	Change Amount	%
Noninterest Income				
Investment and trust services fees	$ 5,370	$ 4,969	$ 401	8.1
Loan service charges	831	714	117	16.4
Deposit service charges and fees	2,399	2,468	(69)	(2.8)
Other service charges and fees	1,327	1,257	70	5.6
Debit card income	1,543	1,469	74	5.0
Increase in cash surrender value of life insurance	521	531	(10)	(1.9)
Net loss on sale of other real estate owned	(26)	(31)	5	16.1
OTTI losses on debt securities	—	(40)	40	100.0
Securities gains, net	3	22	(19)	(86.4)
Other	221	246	(25)	(10.2)
Total	$ 12,189	$ 11,605	$ 584	5.0

2017 versus 2016

The most significant changes in noninterest income are discussed below:

Investment and Trust Service fees: These fees are comprised of asset management fees, estate administration and settlement fees, employee benefit plans, and commissions from the sale of insurance and investment products. Asset management fees are recurring in nature and are affected by the fair value of assets under management at the time the fees are recognized. Asset management fees totaled $4.8 million for 2017, an increase of $428 thousand over 2016. The fair value of trust assets under management increased to $686.9 million at year-end, compared to $622.6 million at the end of 2016. By the nature of an estate settlement, these fees are considered nonrecurring. Estate fees declined by $54 thousand to $243 thousand in 2017. Commissions from the sale of insurance and investment products increased by $26 thousand over 2016.

Loan service charges: This category includes loan origination fees, offset by those fees that are deferred, as well as production fees for originating mortgages for sale in the secondary market, and any fees for loan services that are

charged after origination, e.g.: late fees or debt protection. The primary cause of the increase was higher service charges from commercial loans and fees for mortgages originated through a third-party broker.

Deposit fees: This category is comprised primarily of fees from overdrafts, an overdraft protection program, service charges, and account analysis fees. The decrease in this category is due primarily to lower usage of the Bank's overdraft protection program, resulting in $1.4 million of fees in 2017 compared to $1.5 million in 2016. During the year, fee income from retail usage of this service decreased, but was partially offset by increased usage by commercial customers.

Debit card income: Debit card fees are comprised of both a retail and business card program. Retail fees increased by $45 thousand while business card fees increased $29 thousand, a 10% increase over the prior year. The business debit card offers a cash back rewards program based on usage.

Other service charges and fees: The most significant items in this category include fees from the Bank's merchant card program and ATM fees. Merchant card fees increased $43 thousand while ATM fees increased $13 thousand.

Securities gains and losses, and OTTI charges: The gains in 2017 were solely the result of called bonds. In 2016, $40 thousand of other-than-temporary-impairment charges were recorded on three private-label mortgage-backed securities, while $18 thousand in security gains were the result of called bonds.

The following table presents a comparison of noninterest income for the years ended December 31, 2016 and 2015:

Table 4.1 Noninterest Income

(Dollars in thousands)	2016	2015	Change Amount	%
Noninterest Income				
Investment and trust services fees	$ 4,969	$ 5,036	$ (67)	(1.3)
Loan service charges	714	1,002	(288)	(28.7)
Deposit service charges and fees	2,468	2,318	150	6.5
Other service charges and fees	1,257	1,239	18	1.5
Debit card income	1,469	1,368	101	7.4
Increase in cash surrender value of life insurance	531	551	(20)	(3.6)
Net (loss) gain on sale of other real estate owned	(31)	32	(63)	(196.9)
OTTI losses on debt securities	(40)	(20)	(20)	(100.0)
Gain on conversion of investment security	—	728	(728)	100.0
Securities gains, net	22	8	14	175.0
Other	246	390	(144)	(36.9)
Total	$ 11,605	$ 12,652	$ (1,047)	(8.3)

2016 versus 2015

The most significant changes in noninterest income are discussed below:

Investment and Trust Service fees: Asset management fees increased $176 thousand, while estate fees decreased $187 thousand over 2015. Commissions from the sale of insurance and investment products decreased by $56 thousand compared to the 2015 commissions. The fair value of trust assets under management increased to $622.6 million at year-end, compared to $586.7 million at the end of 2015.

Loan service charges: The primary cause of the decrease in 2016 was lower service charges from commercial loans and a lower volume of consumer debt protection, as well as lower consumer loan originations.

Deposit fees: During 2016, these fees increased $150 thousand compared to 2015. The increase in this category is due primarily to increased enrollment in the Bank’s overdraft protection program, resulting in $1.5 million of fees in

2016 compared to $1.3 million in 2015.

Debit card income: Debit card fees are comprised of both a retail and business card program and the increase in this category was driven primarily by higher retail usage. However, business card usage also increased, but not to the extent as did retail.

Other real estate owned gains (losses), net: The net loss was generated by the sale of five residential properties.

Other: The decrease in this category is the result of an investment the Corporation owned in an offshore insurance company that liquidated in 2015 and paid out the investors ($171 thousand).

Gain on conversion, securities gains and losses, and OTTI charges: In 2016, other-than-temporary-impairment charges were recorded on three private-label mortgage-backed securities, while the security gains were the result of called bonds. In 2015, a gain on conversion of an investment security of $728 thousand was recorded when one bank equity stock owned by the Bank was acquired by another bank. The remaining security gains were generated by the sale of equity securities

Noninterest Expense

The following table presents a comparison of noninterest expense for the years ended December 31, 2017 and 2016:

Table 5. Noninterest Expense

(Dollars in thousands)			Change	
Noninterest Expense	2017	2016	Amount	%
Salaries and benefits	$ 18,871	$ 18,276	$ 595	3.3
Occupancy, furniture and equipment, net	3,152	3,120	32	1.0
Advertising	1,197	1,155	42	3.6
Legal and professional	1,813	1,508	305	20.2
Data processing	2,229	2,093	136	6.5
Pennsylvania bank shares tax	971	902	69	7.6
FDIC insurance	372	580	(208)	(35.9)
ATM/debit card processing	959	855	104	12.2
Foreclosed real estate	151	1,333	(1,182)	(88.7)
Telecommunications	418	429	(11)	(2.6)
Legal reserve	10,000	—	10,000	—
Other	3,039	2,924	115	3.9
Total	$ 43,172	$ 33,175	$ 9,997	30.1

2017 versus 2016

The most significant changes in noninterest expense are discussed below:

Salaries and benefits: This category is the largest noninterest expense category and these expenses increased by $595 thousand compared to the prior year. During the year, salaries, 401(k) contributions and incentive compensation accounted for the largest increases. Partially offsetting the increases were a reduction in pension expense of $463 thousand. Pension expense in 2016 included a one-time pension settlement of $564 thousand. See Note 14 of the accompanying consolidated financial statements for additional information on benefit plans.

Net Occupancy: This category includes all of the expense associated with the properties and facilities used for bank operations such as depreciation, leases, maintenance, utilities and real estate taxes. Building maintenance costs

increased during 2017, but were partially offset by a decrease in depreciation expense.

Legal and professional fees: This category consists of fees paid to outside legal counsel, consultants, and audit fees. The increase was primarily from legal fees associated with a lawsuit brought against the Corporation that is described in Item 3, Legal Proceedings. It is expected that the Corporation will incur additional legal expenses until this lawsuit is fully resolved. Internal and external audit fees increased by $10 thousand.

Data processing: The largest cost in this category is the expense associated with the Bank's core processing system and related services, and accounted for $1.2 million of the total data processing costs, unchanged from the prior year. An increase in software expense contributed $80 thousand to the total increase in this category.

FDIC insurance: This category consists of the total fees paid to the Federal Deposit Insurance Corporation. The expense for 2017 decreased compared to prior year as an improvement in the Bank's credit quality reduced the assessment factor. Also, in the third quarter of 2016, the FDIC lowered the assessment rate on banks with less than $10 billion in assets, as the surplus accumulated in its deposit insurance fund reached the required level and the Bank benefited from this change for the full year of 2017.

Foreclosed real estate: This category consists of expenses related to collecting loans and expenses to carry other real estate owned. The decrease in 2017 was due primarily to a write down the value of one property by $1.2 million in 2016.

Legal Reserve: This expense represents the accrual for a legal settlement described in Item 3 Legal Proceedings.

The following table presents a comparison of noninterest expense for the years ended December 31, 2016 and 2015:

Table 5.1 Noninterest Expense

(Dollars in thousands)			Change	
Noninterest Expense	2016	2015	Amount	%
Salaries and benefits	$ 18,276	$ 17,186	$ 1,090	6.3
Occupancy, furniture and equipment, net	3,120	3,164	(44)	(1.4)
Advertising	1,155	1,105	50	4.5
Legal and professional	1,508	1,093	415	38.0
Data processing	2,093	2,051	42	2.0
Pennsylvania bank shares tax	902	815	87	10.7
FDIC insurance	580	663	(83)	(12.5)
ATM/debit card processing	855	830	25	3.0
Foreclosed real estate	1,333	462	871	188.5
Telecommunications	429	555	(126)	(22.7)
Other	2,924	3,031	(107)	(3.5)
Total	$ 33,175	$ 30,955	$ 2,220	7.2

2016 versus 2015

Salaries and benefits: This category increased by $1.1 million compared to the prior year. Pension expense increased $535 thousand due to pension settlement expense, salary expense increased $489 thousand and health insurance expense increased $114 thousand. These increases were partially offset by a decrease of $112 thousand in 401(k) incentive plan. All other employee benefit expenses remained consistent with 2015 levels.

Net Occupancy: Depreciation expense increased slightly in 2016, but was offset by lower utility expenses and less third party maintenance expenses, due to increased in-house maintenance efforts.

Legal and professional fees: This category increased $415 thousand from 2015. The increase was primarily from legal fees associated with a lawsuit brought against the Corporation in 2015. Internal and external audit fees increased by $93 thousand.

Data processing: The Bank's core processing system and related services, and accounted for $1.2 million of the total data processing costs in 2016 and $1.1 million in 2015. The increase in 2016 was due to higher customer utilization of the Bank's various electronic banking products.

FDIC insurance: The expense for 2016 decreased compared to prior year as an improvement in the Bank's credit quality reduced the assessment factor. Also, in the third quarter of 2016, the FDIC lowered the assessment rate on banks with less than $10 billion in assets, as the surplus accumulated in its deposit insurance fund reached the required level.

Foreclosed real estate: In 2016, the Bank wrote down the value of one property by $1.2 million.

Other: Other noninterest expense decreased in 2016, as the Bank took one-time expenses in 2015 to fulfill the funding requirement of a deferred director's benefit plan established thirty years ago ($70 thousand), and expenses related to branch assets taken out of service in 2015 ($60 thousand).

Provision for Income Taxes

The Corporation recorded a Federal income tax expense of $3.6 million in 2017 compared to $1.3 million in 2016 and $2.3 million in 2015. The effective tax rate for 2017, 2016, and 2015 was 62.1%, 13.9%, and 18.2%, respectively. In most years, the Corporation's effective tax rate is lower than its statutory rate due to the effect of tax-exempt income from certain investment securities, loans, and bank owned life insurance. In 2017, income tax expense and the effective tax rate increased due to the write-down of net deferred tax assets as a result of the passage of the Tax Cuts and Jobs Act of 2017 (the Act) . The Act reduced the federal corporate income tax rate to 21%, effective January 1, 2018 from the Corporation's statutory rate of 34% in prior periods. With the passage of the Act, net deferred tax assets were required to be revalued using the new rate of 21%. The Corporation recorded additional income tax expense of $2.3 million in 2017 as a result of the revaluation of net deferred tax assets. Excluding the effect of the write-down of net deferred tax assets, the effective tax rate for 2017 would have been 22.1%. The Corporation has determined that the accounting for the Tax Cuts and Jobs Act is final as of December 31, 2017.

The income tax provision and effective tax rate were lower in 2016, due to lower pre-tax income as a result of an increase in the provision for loan loss expense, a $1.2 million write-down on an other-real-estate-owned property and more tax-free income in 2016. During 2015, the Corporation reduced the deferred tax valuation allowance related to capital losses by $200 thousand primarily due to a gain on conversion and sale of equity securities. Without this reduction, the effective tax rate for 2015 would have been 19.8% compared to 19.3% in 2014. For a more comprehensive analysis of Federal income tax expense refer to Note 12 of the accompanying consolidated financial statements.

Financial Condition

One method of evaluating the Corporation's condition is in terms of its sources and uses of funds. Assets represent uses of funds while liabilities represent sources of funds. At December 31, 2017, total assets increased 4.7% over the prior year to $1.2 billion from $1.1 billion at the end of 2016.

Interest Bearing Deposits in Other Banks:

This asset increased $17.4 million year-over-year, but the average balance for 2017 remained steady at approximately $31 million. At year-end, approximately $7 million was in the form of short-term certificates of deposit and $30.0 million was held in an interest-bearing account at the Federal Reserve.

Investment Securities:

The investment portfolio serves as a mechanism to invest funds if funding sources out pace lending activity, to provide liquidity for lending and operations, and provide collateral for deposits and borrowings. The mix of securities and investing decisions are made as a component of balance sheet management. Debt securities include U.S. Government Agencies, U.S. Government Agency mortgage-backed securities, non-agency mortgage-backed securities, state and municipal government bonds, and trust preferred securities. The equity portfolio consists of one community bank stock. The average life of the portfolio is 3.5 years and $84.1 million (fair value) is pledged as collateral for deposits. The Bank has no investments in a single issuer that exceeds 10% of shareholders equity. All securities are classified as available for sale and all investment balances refer to fair value, unless noted otherwise. The following table presents the amortized cost and estimated fair value of investment securities by type at December 31 for the past three years:

Table 6. Investment Securities at Amortized Cost and Estimated Fair Value

	2017		2016		2015	
(Dollars in thousands)	Amortized Cost	Fair value	Amortized Cost	Fair value	Amortized Cost	Fair value
Equity securities	$ 164	$ 365	$ 164	$ 290	$ 164	$ 233
U.S. Government and Agency securities	11,451	11,472	12,598	12,720	13,705	13,836
Municipal securities	57,374	57,772	62,763	62,985	67,851	69,188
Trust preferred securities	6,000	5,817	5,979	5,461	5,958	5,289
Agency mortgage-backed securities	51,307	50,937	61,305	61,284	69,284	69,519
Private-label mortgage-backed securities	858	946	1,053	1,104	1,335	1,372
Asset-backed securities	28	27	33	31	38	36
Total	$ 127,182	$ 127,336	$ 143,895	$ 143,875	$ 158,335	$ 159,473

The following table presents investment securities at December 31, 2017 by maturity, and the weighted average yield for each maturity presented. The yields presented in this table are calculated using tax-equivalent interest and the amortized cost.

Table 7. Maturity Distribution of Investment Portfolio

	One year or less		After one year through five years		After five years through ten years		After ten years		Total	
(Dollars in thousands)	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield
Available for Sale										
U.S. Government and Agency securities	$ —	—	$ 4,948	2.08%	$ 2,784	2.53%	$ 3,740	1.85%	$ 11,472	2.12%
Municipal securities	—	—	8,972	3.27%	27,930	3.48%	20,870	3.60%	57,772	3.49%
Trust preferred securities	—	—	—	—	3,056	2.70%	2,761	2.89%	5,817	2.79%
Agency mortgage-backed securities	80	2.04%	3,267	2.35%	7,453	2.54%	40,137	2.46%	50,937	2.46%
Private-label mortgage-backed securities	—	—	—	—	—	—	946	5.16%	946	5.16%
Asset-backed securities	19	0.49%	—	—	—	—	8	3.81%	27	1.47%
Total	$ 99	1.74%	$ 17,187	2.75%	$ 41,223	3.19%	$ 68,462	2.83%	$ 126,971	2.93%

Table 3 shows the three-year trend of average balances and yields on the investment portfolio. The average balances and year-over-year ending balances declined (Table 6), due primarily to cash-flow from called municipal and mortgage-backed securities not being reinvested into the portfolio. The yield on the portfolio declined slightly from 2.80% in 2016 to 2.78% in 2017. U.S. Agency mortgage-backed securities and municipal bonds continue to comprise the largest sectors by fair value of the portfolio, approximately 85% in total. The Bank expects that the portfolio will continue to remain concentrated in these investment sectors. The portfolio produced $23.6 million in cash flows in 2017 while $8.6 million was invested into the portfolio during the year. For the year, the Corporation recorded a gain of $3 thousand on three municipal calls.

Municipal Bonds: The Bank's municipal bond portfolio is well diversified geographically and is comprised of both tax-exempt (72% of the portfolio) and taxable (28% of the portfolio) municipal bonds. General obligation bonds (74%) and revenue bonds (17%) comprise the largest portions of the portfolio. The portfolio holds 106 issues within

28 states. The largest dollar exposure is to issuers in the state of Texas (fair value of $8.4 million / 15 issuers) and Pennsylvania (fair value of $5.1 million / 8 issuers). Thirty-eight percent of the portfolio has either private bond insurance or some other type of credit enhancement. When purchasing municipal bonds, the Bank looks primarily to the underlying credit of the issuer as a sign of credit quality and then to any credit enhancement. Approximately $56 million of the portfolio is rated “A” or higher by a nationally recognized rating agency and the weighted average rating of the portfolio is “Aa2”.

Trust Preferred Bonds: The holdings remain the same as at the prior year end, but the unrealized loss has declined from $518 thousand to $183 thousand year-over-year. The credit ratings for each bond are similar to the ratings one year prior. Trust preferred securities are typically issued by a subsidiary grantor trust of a bank holding company, which uses the proceeds of the equity issuance to purchase deeply subordinated debt issued by the bank holding company. All of the Bank’s trust preferred securities are single issuer bonds. See Note 4 of the accompanying financial statements for more information on the trust preferred securities.

Mortgage-backed Securities (MBS): This sector holds $51.9 million or 41% of the total portfolio. The majority of this sector ($51.0 million) is comprised of U.S. Government Agency MBS. The Government MBS sector is comprised of mortgage backed securities and collateralized mortgage obligations, both fixed and variable rate. In addition, the Bank holds five private-label mortgage-backed securities (PLMBS) with a fair value of $946 thousand and an amortized cost of $858 thousand. The Bank’s private-label mortgage-backed securities (PLMBS) portfolio is comprised primarily of Alt-A loans. Alt-A loans are first-lien residential mortgages that generally conform to traditional “prime” credit guidelines; however, loan factors such as the loan-to-value ratio, loan documentation, occupancy status or property type cause these loans not to qualify for standard underwriting programs. The See Note 4 of the accompanying financial statements for more information on the mortgage-backed securities.

Impairment: Table 8 reflects the temporary impairment in the investment portfolio, aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of December 31, 2017 and 2016.

The condition of the portfolio at year-end 2017, as measured by the dollar amount of temporarily impaired securities, is better than year-end 2016. The Agency Mortgage-backed sector recorded the largest unrealized loss and the greatest number of securities with an unrealized loss.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at December 31, 2017, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted. The following table presents the temporary impairment in the security portfolio for the years presented:

Table 8. Temporary Impairment

	December 31, 2017								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	$ 2,315	$ (11)	5	$ 3,528	$ (32)	10	$ 5,843	$ (43)	15
Municipal securities	13,767	(89)	22	7,507	(163)	14	21,274	(252)	36
Trust preferred securities	1,216								