

ORRSTOWN FINANCIAL SERVICES INC  
Form 10-K  
March 12, 2015  
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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, 2014

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.  
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania  
(State or Other Jurisdiction of  
Incorporation or Organization)

23-2530374  
(I.R.S. Employer  
Identification No.)

77 East King Street, P. O. Box 250,  
Shippensburg, Pennsylvania  
(Address of Principal Executive Offices)

17257  
(Zip Code)

Registrant's Telephone Number, Including Area Code: (717) 532-6114

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered  
The NASDAQ Capital Market

Common Stock, No Par Value

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

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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 (§229.405 of this chapter) 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, or a smaller reporting company. See the definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the Registrant's most recently completed second fiscal quarter, was approximately \$113 million. For purposes of this calculation, the term "affiliate" refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant's common stock.

Number of shares outstanding of the registrant's Common Stock as of March 2, 2015: 8,291,683.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2015 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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PART I

ITEM 1 – BUSINESS

Orrstown Financial Services, Inc. (the “Company”), a Pennsylvania corporation, is the holding company for Orrstown Bank (the “Bank”). The Company’s executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, 17257. The Company was organized on November 17, 1987, for the purpose of acquiring the Bank and such other banks and bank related activities as are permitted by law and desirable. The Bank provides banking and bank related services through 22 offices, located in South Central Pennsylvania, principally in Cumberland, Franklin, Lancaster and Perry Counties and in Washington County, Maryland.

The Company files periodic reports with the Securities and Exchange Commission (“SEC”) in the form of quarterly reports on Form 10-Q, annual reports on Form 10-K, annual proxy statements and current reports on Form 8-K for any significant events that may arise during the year. Copies of these reports, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), may be obtained free of charge through the SEC’s internet site at [www.sec.gov](http://www.sec.gov) or by accessing the Company’s website at [www.orrstown.com](http://www.orrstown.com) as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. Information on our website shall not be considered a part of this Form 10-K.

Business

The Bank was originally organized in 1919 as a state-chartered bank. On March 8, 1988, in a bank holding company reorganization transaction, the Company acquired 100% ownership of the Bank, issuing 131,455 shares of the Company’s common stock to the former shareholders of the Bank.

The Company’s primary activity consists of owning and supervising its subsidiary, the Bank. The day-to-day management of the Company is conducted by its officers, who are also Bank officers. The Company has historically derived most of its income through dividends from the Bank, however, the Bank is prohibited from paying such dividends under an existing enforcement agreement (as more fully discussed below). As of December 31, 2014, the Company, on a consolidated basis, had total assets of \$1,190,443,000, total shareholders’ equity of \$127,265,000 and total deposits of \$949,704,000.

The Company has no employees. Its seven officers are employees of the Bank. On December 31, 2014, the Bank had 296 full-time and 16 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial, residential, consumer and agribusiness loans in its market areas of Cumberland, Franklin, Lancaster and Perry Counties in Pennsylvania and in Washington County, Maryland. The concentrations of credit by type of loan are set forth in Note 4, “Loans Receivable and Allowance for Loan Losses” filed herewith in Part II, Item 8, “Financial Statements and Supplementary Data.” The Bank maintains a diversified loan portfolio and evaluates each customer’s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management’s credit evaluation of the customer pursuant to collateral standards established in the Bank’s credit policies and procedures.

Lending

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided they meet acceptable standards for liquidity and marketability. Loans secured by real estate generally do not exceed 90% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate under the circumstances.

Commercial Lending

A majority of the Company’s loan assets are loans for business purpose. Approximately 65% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank’s various markets.

The Bank’s credit policy dictates the underwriting requirements for the various types of loans the Bank would extend to borrowers. The policy covers such requirements as debt coverage ratios, advance rate against different forms of collateral, loan-to-value ratio (“LTV”) and maximum term.



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### Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans through its branch network. A large majority of the consumer loans are secured by either a first or second lien position on the borrower's primary residential real estate. The Bank requires a LTV of no greater than 90% of the value of the real estate being taken as collateral. The Bank's underwriting standards typically require that a borrower's debt to income ratio generally cannot exceed 43%.

### Residential Lending

The Bank provides residential mortgages throughout its various markets through a network of mortgage loan officers. A majority of the residential mortgages originated are sold to secondary market investors, primarily Wells Fargo, Fannie Mae and the Federal Home Loan Bank of Pittsburgh. All mortgages, regardless of being sold or held in the Bank's portfolio, are generally underwritten to secondary market industry standards for prime mortgages. The Bank requires a LTV of no greater than 80% of the value of the real estate being taken as collateral, without the borrower obtaining private mortgage insurance.

### Loan Review

The Bank has a loan review policy and program which is designed to identify and mitigate risk in the lending function. The Enterprise Risk Management ("ERM") Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank's loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an independent review of the Bank's loan portfolio on an ongoing basis.

Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible negative credit event.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$1,000,000, which include a confirmation of the risk rating by Credit Administration. In addition, all relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank's Loan Work Out Committee.

The Bank outsources its independent loan review to a third party provider, which monitors and evaluates loan customers on a quarterly basis utilizing risk-rating criteria established in the credit policy in order to identify deteriorating trends and detect conditions which might indicate potential problem loans. The third party loan review firm reports the results of the loan reviews quarterly to the ERM Committee for approval. The loan ratings provide the basis for evaluating the adequacy of the allowance for loan losses.

### Orrstown Financial Advisors ("OFA")

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name "Orrstown Financial Advisors." OFA offers retail brokerage services through a third party broker/dealer arrangement with Financial Network Investment Company ("FNIC"). As of December 31, 2014, trust assets under management were \$1,017,013,000.

### Regulation and Supervision

The Company is a bank holding company registered with the Board of Governors of the Federal Reserve System (the "FRB") and has elected status as a financial holding company. As a registered bank holding company and financial holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956 (the "BHC Act") and to inspection, examination, and supervision by the Federal Reserve Bank of Philadelphia (the "Federal Reserve Bank").

The Bank is a Pennsylvania-chartered commercial bank and a member of the Federal Reserve System. As such, the operations of the Bank are subject to federal and state statutes applicable to banks chartered under Pennsylvania law, to FRB member banks and to banks whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The Bank's operations are also subject to regulations of the Pennsylvania Department of Banking and Securities ("PDB"), the FRB and the FDIC.

Several of the more significant regulatory provisions applicable to banks and bank holding companies to which the Company and the Bank are subject are discussed below, along with certain regulatory matters concerning the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, such information is qualified in

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its entirety by reference to the particular statutes or regulations. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

Enforcement

On March 22, 2012, the Company and the Bank entered into a Written Agreement with the Federal Reserve Bank and the Bank entered into a Consent Order with the PDB. The Consent Order with the PDB was subsequently terminated in April 2014, and replaced with a Memorandum of Understanding ("MOU"). On February 6, 2015, the Bank was released from the MOU, thereby terminating all enforcement actions imposed on the Bank by the PDB.

Pursuant to the Written Agreement, the Company and the Bank agreed to, among other things: (i) adopt and implement a plan, acceptable to the Federal Reserve Bank, to strengthen oversight of management and operations; (ii) adopt and implement a plan, acceptable to the Federal Reserve Bank, to reduce the Bank's interest in criticized and classified assets; (iii) adopt a plan, acceptable to the Federal Reserve Bank, to strengthen the Bank's credit risk management practices; (iv) adopt and implement a program, acceptable to the Federal Reserve Bank, for the maintenance of an adequate allowance for loan and lease losses; (v) adopt and implement a written plan, acceptable to the Federal Reserve Bank, to maintain sufficient capital on a consolidated basis for the Company and on a stand-alone basis for the Bank; and (vi) revise the Bank's loan underwriting and credit administration policies. The Bank and the Company also agreed not to declare or pay any dividend without prior approval from the Federal Reserve Bank, and the Company agreed not to incur or increase debt or to redeem any outstanding shares without prior Federal Reserve Bank approval.

The Company and the Bank have developed and continues to implement strategies and action plans to meet the requirements of the Written Agreement. As part of its efforts on complying with the terms of the Written Agreement, the Bank has filed a capital plan with the Federal Reserve Bank.

The Written Agreement will continue until terminated by the Federal Reserve Bank. The foregoing description of the Written Agreement is qualified in its entirety by reference to the actual agreement which is attached as Exhibit 10.13, and incorporated herein by this reference.

Additional regulatory restrictions require prior approval before appointing or changing the responsibilities of directors and executive officers, entering into any employment agreement or other agreement or plan providing for the payment of a "golden parachute payment" or the making of any golden parachute payment.

Financial and Bank Holding Company Activities

In general, the BHC Act and the FRB's regulations limit the nonbanking activities permissible for bank holding companies to those activities that the FRB has determined to be so closely related to banking or managing or controlling banks to be a proper incident thereto. A bank holding company that elects to be treated as a financial holding company, such as the Company, however, may engage in, and acquire companies engaged in, activities that are considered "financial in nature," as defined by the Gramm-Leach-Bliley Act and FRB regulations. For a bank holding company to be eligible to elect financial holding company status, the holding company must be both "well capitalized" or "well managed" under applicable regulatory standards and all of its subsidiary banks must be "well-capitalized" and "well-managed" and must have received at least a satisfactory rating on such institution's most recent examination under the Community Reinvestment Act of 1977 (the "CRA"). A financial holding company that continues to meet all of such requirements may engage directly or indirectly in activities considered financial in nature, either de novo or by acquisition, as long as it gives the FRB after-the-fact notice of the new activities. If a financial holding company fails to continue to meet any of the prerequisites for financial holding company status after engaging in activities not permissible for bank holding companies that have not elected to be treated as financial holding companies, the company must enter into an agreement with the FRB that it will comply with all applicable capital and management requirements. If the financial holding company does not return to compliance within 180 days, or such longer period as agreed to by the FRB, the FRB may order the company to discontinue existing activities that are not generally permissible for bank holding companies or divest the company's investments in companies engaged in such activities. In addition, if any banking subsidiary of a financial holding company receives a CRA rating of less than satisfactory, the company would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies.

FDIC Insurance and Assessments

The Bank's deposits are insured to applicable limits by the FDIC. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the maximum deposit insurance amount was permanently increased from \$100,000 to \$250,000.

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The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution's ranking in one of four risk categories based on their examination ratings and capital ratios. Within its risk category, an institution is assigned an initial base assessment which is then adjusted to determine its final assessment rate based on its level of brokered deposits, secured liabilities and unsecured debt.

The Dodd-Frank Act required the FDIC to take such steps as necessary to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than \$10 billion. The Dodd-Frank Act also broadened the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of a financial institution rather than on its insured deposits. The FDIC has adopted a restoration plan to increase the reserve ratio to 1.15% by September 30, 2020 with additional rulemaking scheduled regarding the method to be used to achieve a 1.35% reserve ratio by that date and offset the effect on institutions with less than \$10 billion in assets.

Pursuant to these requirements, the FDIC adopted new assessment regulations effective April 1, 2011 that redefined the assessment base as average consolidated assets less average tangible equity. Insured banks with more than \$1.0 billion in assets must calculate quarterly average assets based on daily balances while smaller banks and newly chartered banks may use weekly averages. Average assets would be reduced by goodwill and other intangibles. Average tangible equity equals Tier 1 capital. For institutions with more than \$1.0 billion in assets, average tangible equity is calculated on a weekly basis while smaller institutions may use the quarter-end balance. The base assessment rate for insured institutions in Risk Category I will range between 5 to 9 basis points and for institutions in Risk Categories II, III, and IV will be 14, 23 and 35 basis points. An institution's assessment rate will be reduced based on the amount of its outstanding unsecured long-term debt and for institutions in Risk Categories II, III and IV may be increased based on their brokered deposits.

**Liability for Banking Subsidiaries**

Under the Dodd-Frank Act and applicable FRB policy, a bank holding company such as the Company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act (the "FDIA"), the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (1) the "default" of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution "in danger of default."

**Pennsylvania Banking Law**

The Pennsylvania Banking Code ("Banking Code") contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices. The FDIA, however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is significantly restricted by the FDIA.

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## Dividend Restrictions

The Company's funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines. Additional information concerning the Company and the Bank with respect to dividends is incorporated by reference from the risk factors entitled "The Company is subject to restrictions and conditions of a formal agreement issued by the Federal Reserve Bank of Philadelphia. Failure to comply with this formal agreement could result in additional enforcement action against us, including the imposition of monetary penalties" and "The Company discontinued its quarterly cash dividend and suspended the stock repurchase program based on regulatory requirements" included under Item 1A of this report and Note 15, "Restrictions on Dividends, Loans and Advances," of the "Notes to Consolidated Financial Statements" included under Item 8 of this report, and the "Capital Adequacy and Regulatory Matters" section of "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations," included under Item 7 of this report.

## Regulatory Capital Requirements

Information concerning the compliance of the Company and the Bank with respect to capital requirements is incorporated by reference from Note 14, "Shareholders' Equity and Regulatory Capital," of the "Notes to Consolidated Financial Statements" included under Item 8 of this report, and from the "Capital Adequacy and Regulatory Matters" section of the "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations," included under Item 7 of this report.

## Basel III Capital Rules

In July 2013, the Company and Bank's primary federal regulator, the FRB, approved final rules (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and Bank, compared to existing U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios, addresses risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the current risk-weighting approach. The Basel III Capital Rules are effective for the Company and Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called "Common Equity Tier 1" ("CET1"), (ii) specify that Tier 1 capital consist of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments from capital as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) may face constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

Under the Basel III Capital Rules, the initial minimum capital ratios as of January 1, 2015 are as follows:

4.5% CET1 to risk-weighted assets;

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6.0% Tier 1 capital to risk-weighted assets; and

8.0% Total capital to risk-weighted assets.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under previously effective capital standards, the effects of accumulated other comprehensive income items included in capital were excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are not excluded; however, the Company and Bank, may make a one-time permanent election to continue to exclude these items. The Company anticipates it will take advantage of the election.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter until fully phased-in at January 1, 2018). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to the Bank, the Basel III Capital Rules also revise the “prompt corrective action” regulations pursuant to Section 38 of the FDIA, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%), and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories from the four categories of the previous capital standards (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Significant changes to the previously effective capital rules that will impact the Company’s determination of risk-weighted assets include, among other things:

- Greater restrictions on the amount of deferred tax assets that can be included in CET1 capital with assets relating to net operating loss and credit carry forwards being excluded, and a 10% - 15% limitation on deferred tax assets arising from temporary differences that cannot be realized through net operating loss carry backs.

- Applying a 150% risk weight for certain high volatility commercial real estate acquisition, development and construction loans, compared to 100% risk weight previously in place;

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status, compared to 100% risk weight previously in place; and

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, compared to 0% previously in place.

Management is currently evaluating the impact that the Basel III Capital Rules, on a fully phased-in basis, will have on our capital levels. Management anticipates that it will be in compliance with the phased in rules.

**Consumer Financial Protection Bureau**

The Dodd-Frank Act created an independent regulatory body, the Consumer Financial Protection Bureau (“Bureau”), with authority and responsibility to set rules and regulations for most consumer protection laws applicable to all banks, including the Company. The Bureau has responsibility for mortgage reform and enforcement, as well as broad new powers over consumer financial activities which could impact what consumer financial services would be available and how they are provided.

In late 2012, the Bureau formed a Community Bank Advisory Council. Representatives were drawn from small-to-medium-sized community banks to engage in discussions on how smaller institutions help level the playing

field for consumers experiencing difficulty in managing their money and what opportunities and challenges exist in mortgage lending for small institutions. The Bureau has developed prototype designs for various disclosures and agreements and invited the public and financial industry to review and comment on what works. Their website ([www.consumerfinance.gov](http://www.consumerfinance.gov)) serves as a public

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information resource on laws and regulations, assistance with financial questions, participation with projects or initiatives, and submission of complaints. The Bureau has positioned itself to serve as a resource for submission of complaints and to provide help to consumers with complaints regarding credit cards, mortgages, student loans, checking accounts, savings accounts, credit reporting, bank services, and other consumer loans. Guidance and consumer tips on various financial topics have been issued since 2012 in blogs on the Bureau's website. Significant final mortgage rules were issued by the Bureau in January 2013 most with mandatory effective dates in January 2014. These rules were mandated by the Dodd-Frank Act provisions enacted in response to the breakdown in the mortgage lending markets and to provide for consumer protections. The following rules are intended to address problems consumers face in the three major steps in buying a home – shopping for a mortgage, closing on a mortgage, and paying off a mortgage.

Ability-to-Repay (“ATR”) and Qualified Mortgage (“QM”) rules were designed to address concerns that residential mortgage borrowers received loans for which they had no ability to repay. The ATR final rule requires a creditor to make “a reasonable and good faith determination at or before closing that the consumer will have a reasonable ability, at the time of consummation, to repay the loan, according to its terms, including any mortgage-related obligations.” The ATR standards require consideration of eight specific underwriting factors. Information used must be documented and verified using reasonably reliable third-party records. The ATR rule provides for a wide variety of documents and sources of information that can be used and relied on to determine ATR. In addition, the ATR rules included provisions that create a legal advantage for lenders for loans that are qualified mortgages. A QM must have a fully amortizing payment, have a term of 30 years or less, and not have points and fees that exceed certain thresholds depending on the total loan amount. Safe Harbor QM loans are lower priced loans that meet QM requirements. Loans satisfying the QM requirements will be entitled to liability protection from damage claims and defenses by borrowers based on an asserted failure to meet ATR requirements. Rebuttable Presumption QM loans are higher-priced loans that meet QM requirements and provide liability protection to a lesser degree from damage claims and defense by borrowers based on asserted failure to meet ATR requirements.

Loan servicing has become a key focus, especially when loan workouts and modifications are involved. New mortgage servicing rules effective in January 2014 implement new provisions regarding servicing standards. These new standards seek to ensure similar borrowers who default or become delinquent are treated in a similar, consistent manner. The Bank presently services 5,000 or fewer mortgage loans which it owns or originated, so it is considered a “Small Servicer” and is exempt from certain parts of the Mortgage Servicing Rules. The mortgage servicing requirements applicable to the Bank's servicing operations under the new mortgage servicing rules are as follows: 1) adjustable rate mortgage interest rate adjustment notices; 2) prompt payment crediting and payoff statements; 3) limits on force-placed insurance; 4) responses to written information requests and complaints of errors; and 5) loss mitigation with regard to the first notice or filing for a foreclosure and no foreclosure proceedings if a borrower is performing pursuant to the terms of a loss mitigation agreement.

**Other Federal Laws and Regulations**

The Company's operations are subject to additional federal laws and regulations applicable to financial institutions, including, without limitation:

• Privacy provisions of the Gramm-Leach-Bliley Act and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to “opt out” of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;

• Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

• Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the Gramm-Leach-Bliley Act; and the

• USA PATRIOT Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

**Future Legislation and Regulation**

Changes to the laws and regulations in the states where the Company and the Bank do business can affect the operating environment of both the Company and the Bank in substantial and unpredictable ways. The Company cannot accurately predict whether those changes in laws and regulations will occur, and, if those changes occur, the ultimate effect they would have upon

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the financial condition or results of operations of the Company. This is also true of federal legislation, particularly given the current challenging economic environment.

NASDAQ Capital Market

The Company's common stock is listed on The NASDAQ Capital Market under the trading symbol "ORRF" and is subject to NASDAQ's rules for listed companies.

Forward Looking Statements

Additional information concerning the Company and the Bank with respect to forward looking statements is incorporated by reference from the "Caution About Forward Looking Statements" section of the "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this report under Item 7.

Competition

The Bank's principal market area consists of Cumberland County, Franklin County, Lancaster County, and Perry County, Pennsylvania, and Washington County, Maryland. The Bank services a substantial number of depositors in this market area and contiguous counties, with the greatest concentration in Chambersburg, Shippensburg, and Carlisle, Pennsylvania and the surrounding areas.

The Bank, like other depository institutions, has been subjected to competition from less heavily regulated entities such as credit unions, brokerage firms, money market funds, consumer finance and credit card companies, and other commercial banks, many of which are larger than the Bank. The principal methods of competing effectively in the financial services industry include improving customer service through the quality and range of services provided, improving efficiencies and pricing services competitively. The Bank is competitive with the financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

The Bank continues to implement strategic initiatives focused on expanding our core businesses and to explore, on an ongoing basis, acquisition, divestiture, and joint venture opportunities to the extent permitted by our regulators. We analyze each of our products and businesses in the context of shareholder return, customer demands, competitive advantages, industry dynamics, and growth potential.

ITEM 1A – RISK FACTORS

Our financial condition and results of operations may be adversely affected by various factors, many of which are beyond our control. These risk factors include the following:

The Company is subject to restrictions and conditions of a formal agreement issued by the Federal Reserve Bank of Philadelphia. Failure to comply with this formal agreement could result in additional enforcement action against us, including the imposition of monetary penalties.

In March 2012, the Company entered into a Written Agreement with the Federal Reserve Bank of Philadelphia, which requires the Company to discontinue a number of practices and to take a number of actions. In particular, we agreed with the Federal Reserve Bank to, among other things, prepare and submit plans regarding: (i) strengthening of credit risk management practices and underwriting, (ii) the repayment or disposition of properties classified as OREO and nonperforming or criticized assets, (iii) the allowance for loan loss methodology, (iv) capital, and (v) a management review. This formal agreement also restricts the ability of the Company and the Bank to pay dividends, to repurchase stock or to incur indebtedness without prior regulatory approval. We intend to fully comply with the formal agreement. However, if we fail to comply, the Federal Reserve Bank could take additional enforcement action against the Company. Possible enforcement actions could include the issuance of a cease and desist order that could be judicially enforced, the imposition of civil monetary penalties, the issuance of directives to increase capital or to enter into a strategic transaction, whether by merger or otherwise, with a third party, the appointment of a conservator or receiver, the termination of insurance of deposits, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders. Any remedial measure or further enforcement action, whether formal or informal, could impose restrictions on our ability to operate our business, harm our reputation and our ability to retain and attract customers, adversely affect our business, prospects, financial condition or results of operations and impact the trading price of our common stock.

We have incurred and expect to continue to incur additional regulatory compliance expense in connection with these formal agreements. Such additional regulatory compliance costs could have an adverse impact on our results of operations and

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financial condition. In addition, deviations from our business plan will likely have to be approved by the regulators, which could limit our ability to make any changes to our business. This could negatively impact the scope and flexibility of our business activities.

The Company may not be able to pay any cash dividends or conduct any stock repurchases for the foreseeable future. The Company is a bank holding company regulated by the FRB. In October 2011, the Company announced it had discontinued its quarterly dividend. Due to subsequent regulatory restrictions included in the formal agreement with our regulator discussed above, the Company is restricted from paying any dividends or repurchasing any stock without prior regulatory approval. Accordingly, we do not anticipate being able to pay any cash dividends or conducting any stock repurchases until such time as the agreement is lifted.

The Company is a holding company dependent for liquidity on payments from the Bank, its sole subsidiary, which is subject to restrictions.

The Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. Pursuant to the terms of the formal agreement we entered into with the Federal Reserve Bank in March 2012, as discussed above, any dividend or similar payment from the Bank to us may only be made with prior regulatory approval. In 2014, the Bank received regulatory approval to dividend up to \$1,000,000 to the Company as circumstances warrant. In addition, our right to participate in a distribution of assets upon the Bank's liquidation or reorganization is subject to the prior claims of the Bank's creditors.

The Company may be required to make further increases in the provisions for loan losses and to charge off additional loans in the future, which could materially adversely affect it.

There is no precise method of predicting loan losses and the required level of reserves, and related provision for loan losses, can fluctuate from year to year, based on charge-offs (recoveries), loan volumes, credit administration practices, and local and national economic conditions, among other factors. For 2014, we recorded a negative provision for loan losses of \$3,900,000. The Company recorded net charge-offs of \$2,318,000 in 2014 compared to net loan recoveries of \$949,000 in 2013. Risk elements, including nonperforming loans, troubled debt restructurings, loans greater than 90 days past due still accruing, and other real estate owned totaled \$16,464,000 at December 31, 2014. The allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, represents management's best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management's evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses.

In addition, bank regulatory agencies periodically review our allowance for loan losses and may require us to increase the provision for loan losses or to recognize further loan charge-offs, based on judgments that differ from those of management. If loan charge-offs in future periods exceed the allowance for loan losses, there could be a need to record additional provisions to increase our allowance for loan losses. Furthermore, growth in the loan portfolio would generally lead to an increase in the provision for loan losses. Generally, increases in our allowance for loan losses will result in a decrease in net income and stockholders' equity, and may have a material adverse effect on the financial condition of the Company, results of operations and cash flows.

The allowance for loan losses was 2.09% of total loans and 95% of nonaccrual and restructured loans still accruing at December 31, 2014, compared to 3.12% of total loans and 83% of nonaccrual and restructured loans still accruing at December 31, 2013. Material additions to the allowance could materially decrease our net income. In addition, at December 31, 2014, the top 25 lending relationships individually had commitments in excess of \$220,000,000, and a total outstanding loan balance of nearly \$182,097,000, or 26% of the loan portfolio. The deterioration of one or more

of these loans could result in a significant increase in the nonperforming loans and the provisions for loan losses, which would negatively impact our results of operations.

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Difficult economic and market conditions have adversely affected the financial services industry and may continue to materially and adversely affect the Company.

We are operating in a challenging economic environment, including generally uncertain global, national and local conditions. Additional concerns from some of the countries in the European Union, Russian Federation, and elsewhere have also strained the financial markets both abroad and domestically. Although there has been some improvement in the overall global macroeconomic conditions in 2014, financial institutions continue to be affected by conditions in the real estate market and the constrained financial markets. In recent years, declines in the housing market, increases in unemployment and under-employment have negatively impacted the credit performance of loans and resulted in significant write-downs of asset values by financial institutions, including the Bank. Reflecting concern over economic conditions, many lenders and institutional investors have reduced or ceased providing funding to borrowers. While the Company saw continued improvement in 2014, there continued to be stress on the Bank's portfolio. A worsening of economic conditions, or a prolonged inconsistent recovery, may further impact the Bank's results of operations and financial condition. In particular, we may face the following risks in connection with these events:

• Loan delinquencies could increase further;

• Problem assets and foreclosures could increase further;

• Demand for our products and services could decline;

• Collateral for loans made by us, especially real estate, could decline further in value, in turn reducing a customer's borrowing power, and reducing the value of assets and collateral associated with our loans.

As these conditions or similar ones continue to exist or worsen, we may experience continuing or increased adverse effects on our financial condition and results of operations.

Governmental regulation and regulatory actions against us may impair our operations or restrict our growth.

The Company is subject to regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. The Company cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect the Company's financial condition, results of operations, liquidity and stock price.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act includes provisions affecting large and small financial institutions, including several provisions that will profoundly affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage and impose new capital requirements on bank holding companies. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is unclear.

The Dodd-Frank Act also created the Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination

and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Banks and savings institutions with \$10 billion or less in assets will be examined by their applicable bank regulators.

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The Company may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act. Failure to comply with the new requirements may negatively impact our results of operations and financial condition. While the Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, these changes could be materially adverse to our investors.

Changes in interest rates could adversely impact the Company's financial condition and results of operations.

Operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on loans, securities and other interest earning assets and the interest rates we pay on interest-bearing deposits, borrowings and other liabilities. These rates are highly sensitive to many factors beyond our control, including competition, general economic conditions and monetary and fiscal policies of various governmental and regulatory authorities, including the Board of Governors of the FRB. If the rate of interest we pay on our interest-bearing deposits, borrowings and other liabilities increases more than the rate of interest we receive on loans, securities and other interest earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on our loans, securities and other investments fall more quickly than those on our deposits, borrowings and other liabilities. Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate environment.

Additionally, based on an analysis of the interest rate sensitivity of the Company's assets, an increase in the general level of interest rates will negatively affect the market value of the investment portfolio because of the relatively long duration of certain securities included in the investment portfolio.

Changes in interest rates also can affect: (1) the ability to originate loans; (2) the value of interest-earning assets, which would negatively impact stockholders' equity, and the ability to realize gains from the sale of such assets; (3) the ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of borrowers to repay adjustable or variable rate loans.

Increases in FDIC insurance premiums may have a material adverse effect on our results of operations.

Market developments significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. As a result, the Company may be required to pay significantly higher premiums or additional special assessments or taxes that could adversely affect earnings. We are generally unable to control the amount of premiums that are required to be paid for FDIC insurance. If there are additional bank or financial institution failures, the Company may be required to pay even higher FDIC premiums than the levels currently imposed. Any future increases or required prepayments in FDIC insurance premiums may materially adversely affect the results of operations.

Because our business is concentrated in South Central Pennsylvania and Washington County, Maryland, our financial performance could be materially adversely affected by economic conditions and real estate values in these market areas.

Our operations and the properties securing our loans are primarily located in South Central Pennsylvania and in Washington County, Maryland. Our operating results depend largely on economic conditions and real estate valuations in these and surrounding areas. A further deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans, especially real estate, in turn reducing customers' borrowing power, the value of assets associated with nonperforming loans and collateral coverage.

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Commercial real estate lending may expose us to a greater risk of loss and impact our earnings and profitability. Our business strategy involves making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than other loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than other loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to conditions in the real estate market or the local economy. Because of the current challenging economic environment, these loans represent higher risk, could result in an increase in our total net-charge offs and could require us to increase our allowance for loan losses, which could have a material adverse effect on our financial condition or results of operations. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.

The Company is required to make a number of judgments in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to the reports of financial condition and results of operations. Also, changes in accounting standards can be difficult to predict and can materially impact how the Company records and reports our financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, accounting for income taxes and the ability to recognize the deferred tax asset, and the fair value of certain financial instruments, in particular securities. While we have identified those accounting policies that are considered critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could result in a decrease to net income and, possibly, capital and may have a material adverse effect on our financial condition and results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time, the Financial Accounting Standards Board changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations.

Competition from other banks and financial institutions in originating loans, attracting deposits and providing various financial services may adversely affect profitability and liquidity.

We have substantial competition in originating loans, both commercial and consumer loans, in our market area. This competition comes principally from other banks, savings institutions, credit unions, mortgage banking companies and other lenders. Some of our competitors enjoy advantages, including greater financial resources, and higher lending limits, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. This competition could reduce our net income and liquidity by decreasing the number and size of loans that we originate and the interest rates we may charge on these loans.

In attracting business and consumer deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Some of our competitors enjoy advantages, more aggressive marketing campaigns, better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could materially adversely affect our ability to generate the funds necessary for lending operations. As a result, we may need to seek other sources of funds that may be more expensive to obtain and could increase our cost of funds.

The Company's business strategy includes the continuation of moderate growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

In 2014, loans grew \$33,909,000, or 5.1% from \$671,037,000 at January 1, 2014, to \$704,946,000 at December 31, 2014, due to organic growth through increases in consumer lending and commercial real estate loans. Over the long term, we expect to continue to experience growth in loans and total assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to successfully execute our business strategies, which include

continuing to grow our loan portfolio. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards. In addition, since our asset quality metrics have returned closer to historical levels, we may consider the acquisition of other financial institutions and branches within or outside of our market area to the extent permitted by our regulators, the success of which will depend on a number of factors, including our ability to integrate the acquired branches into the current operations of the Company, our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations, our ability to control the incremental increase in non-interest expense arising from any acquisition and our

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ability to retain and integrate the appropriate personnel of the acquired institution or branches. We believe we have the resources and internal systems in place to successfully achieve and manage our future growth. If we do not manage our growth effectively, we may not be able to achieve our business plan, and our business and prospects could be harmed.

If the Company wants to, or is compelled to, raise additional capital in the future, that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require us and our banking subsidiaries to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2014, all three capital ratios for us and our banking subsidiary were above regulatory minimum levels to be deemed “well capitalized” under current bank regulatory guidelines. To be “well capitalized,” banking companies generally must maintain a tier 1 leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6%, and a total risk-based capital ratio of at least 10%.

The Company’s ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital on terms and time frames acceptable to us or to raise additional capital at all. Additionally, the inability to raise capital in sufficient amounts may adversely affect our operations, financial condition and results of operations. Our ability to borrow could also be impaired by factors that are nonspecific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole as evidenced by recent turmoil in the domestic and worldwide credit markets. If we raise capital through the issuance of additional shares of our common stock or other securities, we would likely dilute the ownership interests of current investors and the price at which we issue additional shares of stock could be less than the current market price of our common stock and, thus, could dilute the per share book value and earnings per share of our common stock. Furthermore, a capital raise through the issuance of additional shares may have an adverse impact on our stock price.

The short-term and long-term impact of the changing regulatory capital requirements and new capital rules is uncertain.

In July 2013, the Company and Bank’s primary federal regulator, the Federal Reserve Bank, approved final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and Bank, compared to existing U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions’ regulatory capital ratios, addresses risk weights and other issues affecting the denominator in banking institutions’ regulatory capital ratios and replace the current risk-weighting approach. The Basel III Capital Rules are effective for the Company and Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called CET1, (ii) specify that Tier 1 capital consist of CET1 and “Additional Tier 1 capital” instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments from capital as compared to existing regulations. When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in,

effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The application of more stringent capital requirements to the Company and the Bank could, among other things, result in lower returns on invested capital, result in the need for additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

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The Company may be adversely affected by technological advances.

Technological advances impact our business. The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success may depend, in part, on our ability to address the needs of our current and prospective customers by using technology to provide products and services that will satisfy demands for convenience as well as to create additional efficiencies in operations.

The soundness of other financial institutions could adversely affect the Company.

Our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have historically led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a result of other banks' difficulties or failure, which would increase the capital we need to support such growth.

An interruption or breach in security with respect to our information system, or our outsourced service providers, could adversely impact the Company's reputation and have an adverse impact on our financial condition or results of operations.

We rely on software, communication, and information exchange on a variety of computing platforms and networks and over the Internet. Despite numerous safeguards, we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. We rely on the services of a variety of vendors to meet our data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and we could be exposed to claims from customers. Any of these results could have a material adverse effect on our financial condition, results of operations or liquidity.

Pending litigation and legal proceedings and the impact of any finding of liability or damages could adversely impact the Company and its financial condition and results of operations.

We have been named, from time to time, as a defendant in various legal actions or other proceedings arising in connection with our activities as a financial services institution. Certain of these actions include and future actual or threatened legal actions may include claims for substantial and indeterminate amounts of damages, or may result in other outcomes adverse to us. Legal liability could materially adversely affect our business, financial condition or results of operations or cause us reputational harm, which could harm our business. For more information regarding legal proceedings in which we are involved, see "Legal Proceedings" in Part I, Item 3 herein.

The Company may not be able to attract and retain skilled people.

The Company's success depends, in large part, on our ability to attract and retain skilled people. We recently experienced significant turnover among our senior officers and salary increases, bonuses, and other compensation for our senior executives has been frozen in recent years. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to attract and hire sufficiently skilled people to fill open and newly created positions or to retain current or future employees. An inability to attract and retain individuals with the necessary skills to fill open positions, or the unexpected loss of services of one or more of our key personnel, could have a material adverse impact on our business due to the loss of their skills, knowledge of our markets, years of industry experience or the difficulty of promptly finding qualified replacement personnel.

The market price of our common stock has been subject to volatility.

The market price of the Company's common stock has been subject to fluctuations in response to numerous factors, many of which are beyond our control. These factors include actual or anticipated variations in our operational results and cash flows, changes in financial estimates by securities analysts, trading volume, large purchases or sales of our common stock, market conditions within the banking industry, the general state of the securities markets and the market for stocks of financial institutions, as well as general economic conditions.



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## ITEM 1B – UNRESOLVED STAFF COMMENTS

None.

## ITEM 2 – PROPERTIES

The Bank owns and leases properties in Cumberland, Franklin, Lancaster and Perry Counties, Pennsylvania and Washington County, Maryland as branch banking offices and an operations center. The Company and the Bank maintain headquarters at the Bank's King Street Office in Shippensburg, Pennsylvania. A summary of these properties is as follows:

Office and Address	Acquired/Built	Office and Address	Acquired/Built
Properties Owned		Properties Owned (continued)	
Orrstown Office 3580 Orrstown Road Orrstown, PA 17244	1919	Lincoln Way East Office 1725 Lincoln Way East Chambersburg, PA 17202	2004
Lurgan Avenue Office 121 Lurgan Avenue Shippensburg, PA 17257	1981	Duncannon Office 403 North Market Street Duncannon, PA 17020	2006
King Street Office 77 E. King Street Shippensburg, PA 17257	1986	Greencastle Office 308 Carolle Street Greencastle, PA 17225	2006
Stonehedge Office 427 Village Drive Carlisle, PA 17015	1994	New Bloomfield Office 1 South Carlisle Street New Bloomfield, PA 17068	2006
Path Valley Office 16400 Path Valley Road Spring Run, PA 17262	1995	Newport Office Center Square Newport, PA 17074	2006
Norland Avenue Office 625 Norland Avenue Chambersburg, PA 17201	1997	Red Hill Office 18 Newport Plaza Newport, PA 17074	2006
Silver Spring Office 3 Baden Powell Lane Mechanicsburg, PA 17050	2000	Simpson Street Office 1110 East Simpson Street Mechanicsburg, PA 17055	2006
North Middleton Office (land lease) 2250 Spring Road Carlisle, PA 17013	2002	North Pointe Operations Center Orrstown Operations Center 2695 Philadelphia Avenue Chambersburg, PA 17201	2007
Orchard Drive Office (land lease) 1355 Orchard Drive Chambersburg, PA 17201	2003	Eastern Blvd. Office 1020 Professional Court Hagerstown, MD 21740	2008

Seven Gables Office  
1 Giant Lane  
Carlisle, PA 17013

2003

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Office and Address	Acquired/Built	Office and Address	Acquired/Built
Properties Leased		Properties Leased (continued)	
Hanover Street 22 S. Hanover St. Carlisle, PA 17013	1997	Carlisle Fairgrounds 1000 Bryn Mawr Road Carlisle, PA 17103	2011
Camp Hill 3045 Market St. Camp Hill, PA 17011	2005	Lancaster Financial Center 2098 Spring Valley Road Lancaster, PA 17601	2013

ITEM 3 – LEGAL PROCEEDINGS

The nature of the Company’s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. Except as described in Note 20, “Contingencies” in the Notes to the Consolidated Financial Statements, which information is incorporated herein by reference, in the opinion of management, there are no legal proceedings that are expected to have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

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## PART II

## ITEM 5 – MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## Market Information

Our common stock began trading on the NASDAQ Capital Market under the symbol “ORRF” as of April 28, 2009, and continues to be listed there as of the date hereof. At the close of business on March 2, 2015, there were approximately 3,059 shareholders of record.

The following table sets forth, for the fiscal periods indicated, the high and low sales prices of our common stock for the two most recent fiscal years. Trading prices are based on published financial sources.

	2014		Quarterly Dividend	2013		Quarterly Dividend
	Market Price High	Low		Market Price High	Low	
First quarter	\$17.50	\$15.35	\$0.00	\$15.15	\$9.49	\$0.00
Second quarter	16.95	15.85	0.00	16.20	12.52	0.00
Third quarter	17.00	15.33	0.00	18.00	12.79	0.00
Fourth quarter	17.21	15.50	0.00	17.78	15.45	0.00
			\$0.00			\$0.00

In October 2011, the Company announced that it had discontinued its quarterly dividend. In March 2012, the Company and the Bank entered into a Written Agreement with the Federal Reserve Bank. Due to the regulatory restrictions included in the Written Agreement, the Company is restricted from paying any dividends. Accordingly, there can be no assurance that we will pay a cash dividend in the near future.

## Issuer Purchases of Equity Securities

On September 23, 2010, the Company announced an extension of its original Stock Repurchase Plan authorizing the repurchase of 150,000 shares of its common stock. The maximum number of shares that may yet be purchased under the plan is 146,693 shares at December 31, 2014.

For the quarter ended December 31, 2014, there were no repurchases of common equity securities by the Company under the Stock Repurchase Plan. In connection with the formal written agreement entered into with the Federal Reserve Bank, the Company’s Stock Repurchase Plan was suspended, and the Company does not expect to repurchase shares in the foreseeable future.

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## PERFORMANCE GRAPH

The following graph shows a five-year comparison of the cumulative total return on the Company's common stock as compared to other indexes: the SNL index of banks with assets between \$1 billion and \$5 billion, the S&P 500 Index, and the NASDAQ Composite index. Shareholder returns on the Company's common stock are based upon trades on the NASDAQ Stock Market. The shareholder returns shown in the graph are not necessarily indicative of future performance.

Index	Period Ending					
	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14
Orrstown Financial Services, Inc.	100.00	81.34	25.27	29.52	50.07	52.06
SNL Bank \$1B-\$5B	100.00	113.35	103.38	127.47	185.36	193.81
S&P 500	100.00	115.06	117.49	136.30	180.44	205.14
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16

In accordance with the rules of the SEC, this section captioned "Performance Graph" shall not be incorporated by reference into any of our future filings made under the Exchange Act or the Securities Act of 1933, as amended (the "Securities Act"). The Performance Graph and its accompanying table are not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

## Recent Sales of Unregistered Securities

The Company has not sold any securities within the past three years which were not registered under the Securities Act.

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## ITEM 6 – SELECTED FINANCIAL DATA

(Dollars in thousands)	Year Ended December 31,					
	2014	2013	2012	2011	2010	
<b>Summary of Operations</b>						
Interest income	\$38,183	\$37,098	\$45,436	\$60,361	\$58,423	
Interest expense	4,159	5,011	7,548	10,754	12,688	
Net interest income	34,024	32,087	37,888	49,607	45,735	
Provision for loan losses	(3,900 )	(3,150 )	48,300	58,575	8,925	
Net interest income after provision for loan losses	37,924	35,237	(10,412 )	(8,968 )	36,810	
Securities gains	1,935	332	4,824	6,224	3,636	
Other noninterest income	16,919	17,476	18,438	20,396	19,340	
Goodwill impairment charge	0	0	0	19,447	0	
Other noninterest expenses (excluding goodwill impairment charge)	43,768	43,247	43,349	41,032	36,735	
Income (loss) before income taxes (benefit)	13,010	9,798	(30,499 )	(42,827 )	23,051	
Income tax expense (benefit)	(16,132 )	(206 )	7,955	(10,863 )	6,470	
Net income (loss)	\$29,142	\$10,004	\$(38,454 )	\$(31,964 )	\$16,581	
<b>Per Common Share Data</b>						
Net income (loss)	\$3.59	\$1.24	\$(4.77 )	\$(3.98 )	\$2.18	
Diluted net income (loss)	3.59	1.24	(4.77 )	(3.98 )	2.17	
Cash dividend paid	0.00	0.00	0.00	0.69	0.89	
Book value at December 31	15.40	11.28	10.85	15.92	20.10	
Average shares outstanding – basic	8,110,344	8,093,306	8,066,148	8,017,307	7,609,933	
Average shares outstanding – diluted	8,116,054	8,093,306	8,066,148	8,026,726	7,637,824	
<b>Stock Price Statistics</b>						
Close	\$17.00	\$16.35	\$9.64	\$8.25	\$27.41	
High	17.50	18.00	11.29	29.50	36.50	
Low	15.33	9.49	7.45	7.90	20.00	
Price earnings ratio at close	4.7	13.2	(2.0 )	(2.1 )	12.6	
Diluted price earnings ratio at close	4.7	13.2	(2.0 )	(2.1 )	12.6	
Price to book at close	1.1	1.4	0.9	0.5	1.4	
<b>Year-End Balance Sheet Data</b>						
Total assets	\$1,190,443	\$1,177,812	\$1,232,668	\$1,444,097	\$1,511,722	
Loans	704,946	671,037	703,739	965,440	964,293	
Total investment securities	384,549	416,864	311,774	322,123	440,570	
Deposits – noninterest bearing	116,302	116,371	121,090	111,930	104,646	
Deposits – interest bearing	833,402	884,019	963,949	1,104,972	1,083,731	
Total deposits	949,704	1,000,390	1,085,039	1,216,902	1,188,377	
Repurchase agreements	21,742	9,032	9,650	15,013	87,850	
Borrowed money	79,812	66,077	37,470	73,798	65,178	
Total shareholders' equity	127,265	91,439	87,694	128,197	160,484	
Trust assets under management – market value	1,017,013	1,085,216	992,378	947,273	929,327	
<b>Performance Statistics</b>						
Average equity / average assets	8.63	% 7.45	% 8.07	% 10.36	% 10.76	%
Return on average equity	28.78	% 11.30	% (35.22 )	%) (20.33	%) 11.22	%
Return on average assets	2.48	% 0.84	% (2.84 )	%) (2.11	%) 1.21	%



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ITEM 7 – MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of the consolidated financial condition and results of operations for each of the three years ended December 31, 2014, 2013 and 2012. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of the Company’s 2014 performance. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications. It should also be read in conjunction with the “Caution About Forward Looking Statements” section at the end of this discussion.

Overview

The U.S. economy is in its fifth year of recovery from one of its longest and most severe economic recessions in recent history. The strength of the recovery has been modest by historical standards with GDP growth struggling to sustain momentum above 2.0%. Unemployment had been slow to decline until 2014, when it experienced its best employment growth in over a decade adding over three million new jobs. While the economic outlook finally appears strong enough that the Federal Reserve is expected to begin raising interest rates in mid-2015, most of the rest of the world's economies appear to be in recession or experiencing decelerating growth. As a result, the dollar has strengthened significantly and commodity prices have fallen precipitously. It remains to be seen if the U.S. economy will remain strong enough to allow the Federal Reserve to raise interest rates while the rest of the world's major economies struggle.

The Company returned to profitability for the years ended December 31, 2014 and 2013, recording net income of \$29,142,000 and \$10,004,000 after posting losses in the two previous years, including \$38,454,000 in 2012. The Company was able to return to profitability as asset quality issues have improved significantly in the past two years, from their elevated levels, allowing for significant reductions in the provision for loan losses in 2014 and 2013 compared to 2012. The provision for loan losses was a negative \$3,900,000 and \$3,150,000 for the years ended December 31, 2014 and 2013, compared to \$48,300,000 in 2012.

The results of operation of the Company was also influenced by the establishment of a deferred tax asset valuation allowance reserve totaling \$20,235,000 in 2012 due primarily to the cumulative losses posted in 2011 and 2012. As a result of sustained profitability for the last nine quarters, strengthened asset quality metrics and regulatory capital, the valuation allowance was recaptured in the fourth quarter of 2014, and an income tax benefit of \$16,204,000 was recorded.

Critical Accounting Policies

The Company’s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and follow general practices within the financial services industry in which it operates. Management, in order to prepare the Company’s consolidated financial statements, is required to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date through the date the financial statements are filed with the SEC. As this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources.

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to

the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the allowance for loan losses and accounting for income taxes as critical accounting policies.

The allowance for loan losses represents management's estimate of probable incurred credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of

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current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet.

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management's judgment it is "more likely than not" that some portion of the asset will not be realized. Management may need to modify their judgments in this regard from one period to another should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company's ability to benefit from the asset in the future. Based upon the Company's prior cumulative taxable losses, projections for future taxable income and other available evidence, management determined that there was not sufficient positive evidence to outweigh the cumulative loss, and concluded it was not more likely than not that the net deferred tax asset would be realized for the quarters ended September 30, 2012 through September 30, 2014. Accordingly a full valuation allowance was recorded for each of these quarters. However, at December 31, 2014, management noted the Company's profitable operations over the past nine quarters, improvements in asset quality, strengthened capital position, reduced regulatory risk, as well as improvement in economic conditions. Based on this analysis, management determined that a full valuation allowance was no longer necessary, and the full amount was recaptured as of December 31, 2014. The ultimate realization of deferred tax assets is dependent upon existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered projected future taxable income, length of time needed for carryforwards to reverse, available tax planning strategies, and other factors in making its assessment that it was more likely than not the net deferred tax assets would be realized, and recaptured the full valuation allowance at December 31, 2014.

Readers of the consolidated financial statements should be aware that the estimates and assumptions used in the Company's current financial statements may need to be updated in future financial presentations for changes in circumstances, business or economic conditions in order to fairly represent the condition of the Company at that time.

**Corporate Profile and Significant Developments**

The Company is a bank holding company (that has elected status as a financial holding company with the FRB) headquartered in Shippensburg, Pennsylvania with consolidated assets of \$1,190,443,000 at December 31, 2014. The consolidated financial information presented herein reflects the Company and its wholly-owned commercial bank subsidiary, the Bank.

The Bank, with total assets of \$1,190,114,000 at December 31, 2014, is a Pennsylvania chartered commercial bank with 22 offices. The Bank's deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors, a division of the Bank, offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2014, Orrstown Financial Advisors had approximately \$1,017,013,000 of assets under management.

**Economic Climate, Inflation and Interest Rates**

The U.S. economy appears to be recovering from one of its longest and most severe economic recessions in history. The recovery has been much weaker than past recoveries resulting in poor loan demand and continued credit quality challenges. This pattern remained in place throughout 2014.

The majority of the assets and liabilities of a financial institution are monetary in nature, and therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an impact on the growth of total assets and on noninterest expenses, which tend to rise during periods of general inflation. Inflationary pressures over the last three years have been modest, and although the FRB has been monetizing the debt, which has historically led to increased inflation, the outlook for inflation appears modest for the foreseeable future.

As the Company's balance sheet consists primarily of financial instruments, interest income and interest expense is greatly influenced by the level of interest rates and the slope of the interest rate curve. During the three years presented in this financial statement review, interest rates have remained near all-time lows. Because of the low level of interest rates, we have not been able to lower the rate we pay for interest bearing non-maturity deposits to the same extent that has been experienced in the rates we have been able to earn on our interest earning assets. As a result, the Company's net interest margin has been negatively impacted.

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Despite the challenging economic conditions during 2012 - 2014, the Company believes it is positioned to withstand these conditions through its improving capital and liquidity positions, high quality debt securities portfolios and recent improvement in asset quality through continuing efforts to manage credit and interest rate risk.

## Results of Operations

## Summary

For the years ended December 31, 2014 and 2013, the Company recorded net income of \$29,142,000 and \$10,004,000, compared to a net loss of \$38,454,000 for the same period in 2012. Diluted earnings (loss) per share were \$3.59, \$1.24 and (\$4.77) for the years ended December 31, 2014, 2013 and 2012.

Each of the three years had events and circumstances that affect the comparability of the information for the periods presented, and reflects the impact that asset quality had on the results of our operations. In 2012, the Company continued to identify troubled loans, and due to the aggressive manner in which these assets were handled, a \$48,300,000 provision for loan losses was recorded. Improvements were noted in asset quality beginning in 2013, and with some success in remediation and workout efforts, it was determined that no provision for loan losses was needed for 2013 and 2014, and that a recovery of amounts previously provided for or charged off would be recognized. This resulted in a negative provision of \$3,900,000 and \$3,150,000 for the years ended December 31, 2014 and 2013.

Noninterest expenses, in total, remained relatively consistent, and totaled \$43,768,000, \$43,247,000 and \$43,349,000 for the years ended December 31, 2014, 2013 and 2012. Although the total was relatively flat, the changes in certain components of noninterest expenses between the three periods are reflective of the Company's asset quality remediation efforts, and focus on investing in additional talent and technology to better serve the needs of our customers, and efforts to develop new relationships. Collection, problem loan, and real estate owned expenses decreased from \$3,131,000 for the year ended December 31, 2012 to \$811,000 and \$1,029,000 for the years ended December 31, 2013 and 2014. Salaries and employee benefits increased from \$19,864,000 for the year ended December 31, 2012 to \$22,954,000 and \$23,658,000 for the years ended December 31, 2013 and 2014.

For the year ended December 31, 2014, net income benefited from the recapture of the valuation allowance on deferred tax assets of \$16,204,000, that was established and charged to income tax expense in 2012, and negatively impacted results of operation by \$20,235,000 in that year. As a result of the recapture of the full valuation that was established in 2012, an income tax benefit of \$16,132,000 was recorded in 2014, despite pre-tax income of \$9,798,000.

## Net Interest Income

Net interest income, which is the difference between interest income and fees on interest-earning assets and interest expense on interest-bearing liabilities, is the primary component of the Company's revenue. Interest-earning assets include loans, securities and federal funds sold. Interest bearing liabilities include deposits and borrowed funds. To compare the tax-exempt yields to taxable yields, amounts are adjusted to pretax equivalents based on a 35% federal corporate tax rate.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities and the composition of those assets and liabilities. The "net interest spread" and "net interest margin" are two common statistics related to changes in net interest income. The net interest spread represents the difference between the yields earned on interest-earning assets and the rates paid for interest-bearing liabilities. The net interest margin is defined as the ratio of net interest income to average earning assets. Through the use of demand deposits and stockholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are non-interest bearing.

The "Analysis of Net Interest Income" table presents net interest income on a fully taxable equivalent basis, net interest spread and net interest margin for the years ending December 31, 2014, 2013 and 2012. The "Changes in Taxable Equivalent Net Interest Income" table below analyzes the changes in net interest income for the same periods broken down by their rate and volume components.

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## 2014 versus 2013

For the year ended December 31, 2014, net interest income, measured on a fully tax equivalent basis, increased \$1,612,000, or 4.8%, to \$35,494,000 from \$33,882,000 for the same period in 2013. The primary reason for the increase in net interest income was the investment of excess liquidity, previously kept in interest bearing bank balances, into higher yielding securities and the loan portfolio. Expansion in net interest margin from 3.03% for the year ended December 31, 2013 to 3.20% for the same period in 2014 reflects the investments in the higher yielding securities and loans. This shift in investment philosophy was made possible as a result of the sustained improvement in the Company's asset quality and earnings performance, beginning in the fourth quarter of 2013, which allowed for increased liquidity available at our correspondent banks, and decreasing the amount of liquidity we needed on hand. Average earning assets decreased nominally from \$1,118,612,000 for the year ended December 31, 2013 to \$1,111,087,000 for the same period in 2014.

The largest contributor to the increase in net interest income was the investment of excess liquidity into the securities portfolio. Interest income on securities increased from \$5,940,000 for the year ended December 31, 2013 to \$8,899,000 for the year ended December 31, 2014. The average securities balance increased to \$413,072,000 for the year ended December 31, 2014, compared to \$368,208,000 for the same period in 2013. The average yield on the securities portfolio improved from 1.61% for the year ended December 31, 2013 to 2.15% for the same period in 2014. The change in interest income due to the increase in the average yield on investment securities resulted in additional interest income of \$3,039,000 and was the primary contributor to the \$2,959,000 increase in the interest income earned on securities in 2014 compared to 2013.

Interest income earned on a tax equivalent basis on loans decreased in 2014 and totaled \$30,719,000 for the year ended December 31, 2014, a decrease of \$2,060,000 compared to the \$32,779,000 for the same period in 2013.

Although the average balance of loans has increased marginally from \$683,272,000 for the year ended December 31, 2013 to \$683,878,000 for the same period in 2014, the volume increase was not enough to offset the decrease in rates earned on loans, which declined from an average tax equivalent yield of 4.80% in 2013 to 4.49% in 2014.

Interest expense on deposits and borrowings for the year ended December 31, 2014 was \$4,159,000, a decrease of \$852,000, from \$5,011,000 for the same period in 2013. The average balance of interest bearing liabilities decreased 3.30% from \$968,797,000 for the year ended December 31, 2013 to \$936,831,000 for the same period in 2014. In addition, the Company's cost of funds on interest bearing liabilities declined to 0.44% for the year ended December 31, 2014 from 0.52% for the same period in 2013. As time deposits matured, we have been able to replace the funds at lower rates.

During the year ended December 31, 2014, the Company utilized short-term borrowings as a temporary funding source of funds, rather than utilizing more expensive time deposits and long-term borrowings. As a result, the average balance of short-term borrowings increased \$27,610,000 during the year, and averaged \$51,922,000. In addition, the average rate paid on short-term borrowings for 2014 was 0.29% an increase of 4 basis points from that paid in 2013. The increase in average balances and rates paid resulted in an increase in interest expense on short-term borrowings from \$61,000 for the year ended December 31, 2013 to \$148,000 in 2014. Conversely, the Company allowed its long-term borrowings to run off without full replacement, resulting in a lower average balance of \$17,773,000 for the year ended December 31, 2014 compared to \$28,752,000 in 2013. This was a reason that interest expense on long-term debt decreased by \$172,000, from \$505,000 for the year ended December 31, 2013 to \$333,000. Offsetting the lower average balances were higher average rates paid, which increased from 1.76% in 2013 to 1.87% in 2014, as some of the maturing long-term debt had rates below the average of the total.

The Company's net interest spread of 3.13% increased 17 basis points for the year ended December 31, 2014 as compared to the same period in 2013. Net interest margin for the year ended December 31, 2014 was 3.20%, a 17 basis point improvement from 3.03% for the year ended December 31, 2013.

## 2013 versus 2012

For the year ended December 31, 2013, net interest income, measured on a fully tax equivalent basis, decreased \$6,271,000, or 15.6%, to \$33,882,000 from \$40,153,000 for 2012. The primary reason for the decrease in net interest income was a decrease in average earning assets from \$1,284,864,000 for the year ended December 31, 2012 to \$1,118,612,000 for 2013. Compression in net interest margin from 3.12% for the year ended December 31, 2012 to

3.03% for 2013 also contributed to the decline in net interest income.

The largest contributor to the decrease in average earning assets was the decline in the loan portfolio. Interest income on loans decreased from \$40,994,000 for the year ended December 31, 2012 to \$32,779,000 for the year ended December 31, 2013. The average loan balance declined to \$683,272,000 for the year ended December 31, 2013, compared to \$859,985,000 for 2012. Two large sales of criticized loans in 2012 resulted in lower average balances, as did management's workout efforts and scheduled amortization of loans exceeding new loan originations during the year. Partially offsetting the loan volume

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variance was an increase in average rates earned on loans from 4.77% for the year ended December 31, 2012 to 4.80% for 2013, as the Company has been able to reduce its nonaccrual loan balance.

Securities interest income also declined in 2013 and totaled \$5,940,000 for the year ended December 31, 2013, a decrease of \$480,000 compared to the \$6,420,000 for 2012. Although the average balance of securities has increased from \$315,581,000 for the year ended December 31, 2012 to \$368,208,000 for 2013, the volume increase was not enough to offset the decrease in rates earned on securities, which declined from a tax equivalent yield of 2.03% in 2012 to 1.61% in 2013. The low interest rate environment experienced during the first half of 2013 resulted in increased refinancing activity and accelerated prepayments on mortgage backed securities and collateralized mortgage obligations, many of which have premiums associated with them. Furthermore, the proceeds from the sales or maturities of securities had been reinvested at lower interest rates, also negatively impacting the yield earned on securities.

Interest expense on deposits and borrowings for the year ended December 31, 2013 was \$5,011,000, a decrease of \$2,537,000, from \$7,548,000 for 2012. The average balance of interest bearing liabilities decreased 13.2% from \$1,115,644,000 for the year ended December 31, 2012 to \$968,797,000 for 2013. In addition, the Company's cost of funds on interest bearing liabilities declined to 0.52% for the year ended December 31, 2013 from 0.68% for 2012. The interest rate environment allowed the Company to lower the rates offered on its demand deposits, including interest bearing demand, money market and savings in 2013 compared to 2012, and as time deposits mature, replacement funds were at slightly lower rates. The rate paid on long-term debt had increased from 1.64% for the year ended December 31, 2012 to 1.76% for 2013, a direct result of the maturity of lower cost borrowings.

The Company's net interest spread of 2.96% declined 7 basis points for the year ended December 31, 2013 as compared to 2012. Net interest margin for the year ended December 31, 2013 was 3.03%, a 9 basis point decline from 3.12% for the year ended December 31, 2012.

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## ANALYSIS OF NET INTEREST INCOME

The following table presents interest income on a fully taxable equivalent basis, net-interest spread and net interest margin for the years ended December 31:

	2014			2013			2012			
(Dollars in thousands)	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	
Assets										
Federal funds sold and interest bearing bank balances	\$14,137	\$35	0.25 %	\$67,132	\$174	0.26 %	\$109,298	\$287	0.26 %	
Taxable securities	399,014	8,051	2.02	339,750	4,300	1.27	270,170	3,798	1.41	
Tax-exempt securities	14,058	848	6.03	28,458	1,640	5.76	45,411	2,622	5.77	
Total securities	413,072	8,899	2.15	368,208	5,940	1.61	315,581	6,420	2.03	
Taxable loans	620,701	27,368	4.41	619,929	29,290	4.72	796,873	37,145	4.66	
Tax-exempt loans	63,177	3,351	5.30	63,343	3,489	5.51	63,112	3,849	6.10	
Total loans	683,878	30,719	4.49	683,272	32,779	4.80	859,985	40,994	4.77	
Total interest-earning assets	1,111,087	39,653	3.57	1,118,612	38,893	3.48	1,284,864	47,701	3.71	
Cash and due from banks	14,161			13,166			14,597			
Bank premises and equipment	25,921			26,496			27,043			
Other assets	41,499			52,179			62,856			
Allowance for loan losses	(19,268 )			(21,912 )			(37,133 )			
Total	\$1,173,400			\$1,188,541			\$1,352,227			
Liabilities and Shareholders' Equity										
Interest bearing										
demand deposits	\$491,046	823	0.17	\$484,114	785	0.16	\$511,800	1,236	0.24	
Savings deposits	83,941	135	0.16	78,714	129	0.16	74,180	124	0.17	
Time deposits	292,149	2,720	0.93	352,905	3,531	1.00	455,507	5,352	1.17	
Short-term borrowings	51,922	148	0.29	24,312	61	0.25	30,581	120	0.39	
Long-term debt	17,773	333	1.87	28,752	505	1.76	43,576	716	1.64	
Total interest bearing liabilities	936,831	4,159	0.44	968,797	5,011	0.52	1,115,644	7,548	0.68	
	123,224			119,146			116,930			

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Demand deposits									
Other	12,095			12,051				10,469	
Total Liabilities	1,072,150			1,099,994				1,243,043	
Shareholders' Equity	101,250			88,547				109,184	
Total	\$1,173,400			\$1,188,541				\$1,352,227	
Net interest income (FTE)/net interest spread		35,494	3.13 %		33,882	2.96 %		40,153	3.03 %
Net interest margin			3.20 %			3.03 %			3.12