POWER INTEGRATIONS INC
Form 4
May 07, 2014

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
Matthews David MH

(Last) (First) (Middle)

5245 HELLYER AVE

(Street)

SAN JOSE, CA 95138

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
POWER INTEGRATIONS INC [POWI]

3. Date of Earliest Transaction (Month/Day/Year)
05/06/2014

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
VP of Product Development

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	05/06/2014		D		283	D	$ 48.3477	20,105	D	
Common Stock	05/06/2014		D		290	D	$ 48.3477	19,815	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Matthews David MH 5245 HELLYER AVE SAN JOSE, CA 95138			VP of Product Development	

Signatures

By: /s/ Eric Verity Attorney In Fact For: David MH Matthews	05/07/2014
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ential construction

201

0

201

492

0

492

Commercial and industrial
309

0

309

350

0

350

Residential mortgage:

First lien
1,852

1,079

2,931

2,734

1,102

3,836

Home equity - term
18

0

18

22

0

22

Home equity - lines of credit
701

25

726

438

29

467

Installment and other loans
0

0

0

11

0

11

$
5,458

$
1,143

$
6,601

$
9,843

$
1,183

$
11,026

The following table presents our exposure to borrowers with impaired loans, partial charge-offs taken to date and specific reserves established on the borrowing relationships at September 30, 2018 and December 31, 2017. Of the relationships deemed to be impaired at September 30, 2018, none had a recorded balance in excess of $1,000,000 and 63, or 77.1%, of total impaired loans, had recorded balances of less than $250,000.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves
September 30, 2018				
Relationships greater than $1,000,000	0	$ 0	$ 0	$ 0
Relationships greater than $500,000 but less than $1,000,000	1	828	17	0
Relationships greater than $250,000 but less than $500,000	2	685	0	0
Relationships less than $250,000	63	5,088	873	39
	66	$ 6,601	$ 890	$ 39
December 31, 2017				
Relationships greater than $1,000,000	1	$ 4,065	$ 791	$ 0
Relationships greater than $500,000 but less than $1,000,000	1	518	145	0
Relationships greater than $250,000 but less than $500,000	4	1,501	120	0
Relationships less than $250,000	62	4,942	1,160	51
	68	$ 11,026	$ 2,216	$ 51

The Company takes partial charge-offs on collateral-dependent loans when carrying value exceeds estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. Impairment reserves remain in place if updated appraisals are pending, and represent management's estimate of potential loss, or on restructured loans that are still accruing, and the impairment is based on discounted cash flows. Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. Credit Administration also reviews loans in excess of $1,000,000. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any reserves that may be needed. The determination of the Company’s charge-offs or impairment reserve include an evaluation of the outstanding loan balance and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships at September 30, 2018. However, over time, additional information may

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result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

The Company’s OREO totaled $286,000 at September 30, 2018 and consisted of one commercial and one residential property. The decrease in OREO from $961,000 at December 31, 2017 was principally the result of the sale of two properties at modest gains in the second quarter of 2018. All properties are carried at the lower of cost or fair value, less costs to dispose.

At September 30, 2018, the Company believes the value of OREO represents the properties' fair values, but if the real estate market changes, additional charges may be needed.

Credit Risk Management

Allowance for Loan Losses

The Company maintains the ALL at a level deemed adequate by management for probable incurred credit losses. The ALL is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology which considers specific credit evaluation of impaired loans, past loan loss historical experience and qualitative factors. Management addresses the requirements for loans individually identified as impaired, loans collectively evaluated for impairment, and other bank regulatory guidance in its assessment.

The ALL is evaluated based on management's review of the collectability of loans in light of historical experience; the nature and volume of the loan portfolio; adverse situations that may affect a borrower’s ability to repay; estimated value of any underlying collateral; and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve is included in Note 4, Loans Receivable and Allowance for Loan Losses, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information."

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The following table summarizes the Company's internal risk ratings at September 30, 2018 and December 31, 2017:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
September 30, 2018						
Commercial real estate:						
Owner occupied	$114,871	$1,962	$ 275	$ 1,948	$ 0	$119,056
Non-owner occupied	239,429	5,700	4,400	0	0	249,529
Multi-family	68,981	5,468	726	139	0	75,314
Non-owner occupied residential	82,381	744	1,144	329	0	84,598
Acquisition and development:						
1-4 family residential construction	10,016	0	0	201	0	10,217
Commercial and land development	33,120	25	590	0	0	33,735
Commercial and industrial	124,819	1,883	0	309	0	127,011
Municipal	39,429	0	0	0	0	39,429
Residential mortgage:						
First lien	164,247	0	0	2,931	0	167,178
Home equity - term	10,495	0	0	18	0	10,513
Home equity - lines of credit	134,716	77	59	726	0	135,578
Installment and other loans	32,783	0	0	0	0	32,783
	$1,055,287	$15,859	$ 7,194	$ 6,601	$ 0	$1,084,941
December 31, 2017						
Commercial real estate:						
Owner occupied	$113,240	$413	$ 1,921	$ 1,237	$ 0	$116,811
Non-owner occupied	235,919	0	4,507	4,065	0	244,491
Multi-family	48,603	4,113	753	165	0	53,634
Non-owner occupied residential	76,373	142	1,084	381	0	77,980
Acquisition and development:						
1-4 family residential construction	11,238	0	0	492	0	11,730
Commercial and land development	18,635	5	611	0	0	19,251
Commercial and industrial	113,162	2,151	0	350	0	115,663
Municipal	42,065	0	0	0	0	42,065
Residential mortgage:						
First lien	158,673	0	0	3,836	0	162,509
Home equity - term	11,762	0	0	22	0	11,784
Home equity - lines of credit	131,585	80	60	467	0	132,192
Installment and other loans	21,891	0	0	11	0	21,902
	$983,146	$6,904	$ 8,936	$ 11,026	$ 0	$1,010,012

Potential problem loans are defined as performing loans which have characteristics that cause management concern over the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as nonperforming loans in the future. Generally, management feels that Substandard loans that are currently performing and not considered impaired result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans. Additionally, the Special Mention classification is intended to be a temporary classification reflective of loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Company's position at some future date. Special Mention loans represent an elevated risk, but their weakness does not yet justify a classified (Substandard, Doubtful, or Loss) rating. These loans require inquiry by lenders on the cause of the potential weakness and, once analyzed, the loan classification may be downgraded to Substandard or, alternatively, could be upgraded to Pass.

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The following table summarizes activity in the ALL for the three and nine months ended September 30, 2018 and 2017.

(Dollars in thousands)	Commercial Commercial Real Estate	Commercial Acquisition and Development	Commercial Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Installment and Other	Total	Unallocated	Total
Three Months Ended										
September 30, 2018										
Balance, beginning of period	$6,680	$ 720	$ 1,598	$ 80	$9,078	$3,544	$ 230	$3,774	$ 585	$13,437
Provision for loan losses	194	19	(38)	(1)	174	(45)	146	101	(75)	200
Charge-offs	(17)	0	0	0	(17)	(62)	(80)	(142)	0	(159)
Recoveries	200	0	1	0	201	102	31	133	0	334
Balance, end of period	$7,057	$ 739	$ 1,561	$ 79	$9,436	$3,539	$ 327	$3,866	$ 510	$13,812
September 30, 2017										
Balance, beginning of period	$6,777	$ 579	$ 1,291	$ 117	$8,764	$3,386	$ 131	$3,517	$ 470	$12,751
Provision for loan losses	(102)	(90)	191	(12)	(13)	(12)	74	62	51	100
Charge-offs	0	0	(30)	0	(30)	(54)	(51)	(105)	0	(135)
Recoveries	0	1	1	0	2	41	12	53	0	55
Balance, end of period	$6,675	$ 490	$ 1,453	$ 105	$8,723	$3,361	$ 166	$3,527	$ 521	$12,771
Nine Months Ended										
September 30, 2018										
Balance, beginning of period	$6,763	$ 417	$ 1,446	$ 84	$8,710	$3,400	$ 211	$3,611	$ 475	$12,796
Provision for loan losses	(217)	319	114	(5)	211	157	197	354	35	600
Charge-offs	(17)	0	0	0	(17)	(148)	(198)	(346)	0	(363)
Recoveries	528	3	1	0	532	130	117	247	0	779
Balance, end of period	$7,057	$ 739	$ 1,561	$ 79	$9,436	$3,539	$ 327	$3,866	$ 510	$13,812
September 30, 2017										
Balance, beginning of period	$7,530	$ 580	$ 1,074	$ 54	$9,238	$2,979	$ 144	$3,123	$ 414	$12,775
Provision for loan losses	(840)	(93)	458	51	(424)	429	88	517	107	200
Charge-offs	(45)	0	(85)	0	(130)	(105)	(107)	(212)	0	(342)
Recoveries	30	3	6	0	39	58	41	99	0	138
Balance, end of period	$6,675	$ 490	$ 1,453	$ 105	$8,723	$3,361	$ 166	$3,527	$ 521	$12,771

The ALL at September 30, 2018, increased $1,016,000 from December 31, 2017, reflecting the $600,000 provision for loan losses and net recoveries during the period. Net recoveries totaled $175,000 and $416,000 for the three and nine months ended September 30, 2018 compared with net charge-offs of $80,000 and $204,000 for the same periods in 2017. The net recoveries in 2018 were principally due to the commercial real estate loan previously noted. The ratio of annualized net charge-offs (recoveries) to average loans outstanding was (0.06)% and (0.05)% for the three and nine months ended September 30, 2018 compared with 0.03% for both periods in 2017. Classified loans totaled $13,795,000 at September 30, 2018, or 1.3% of total loans outstanding, and decreased from $19,962,000 at December 31, 2017, or 2.0% of loans outstanding. The asset quality ratios previously noted are indicative of the continued benefit the Company has received from favorable historical charge-off statistics and generally stable economic and market conditions for the last few years, even while the loan portfolio has been growing. Recent loan growth trends contributed to management's determination that a provision for loan losses in the first three quarters of 2018 was required to maintain an adequate ALL, with an ALL to total loans ratio of 1.27% at September 30, 2018, which was the same as December 31, 2017.

Despite generally favorable historical charge-off data and stable and economic and market conditions, the growth the Company has experienced in its loan portfolio may result in the need for additional provisions for loan losses in future quarters.

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The following table summarizes the ending loan balances individually or collectively evaluated for impairment based on loan type, as well as the ALL allocation for each, at September 30, 2018 and December 31, 2017.

(Dollars in thousands)	Commercial Real Estate	Commercial Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Consumer Installment and Other	Total	Unallocated	Total
September 30, 2018										
Loans allocated by:										
Individually evaluated for impairment	$2,416	$201	$309	$0	$2,926	$3,675	$0	$3,675	$0	$6,601
Collectively evaluated for impairment	526,081	43,751	126,702	39,429	735,963	309,594	32,783	342,377	0	1,078,340
	$528,497	$43,952	$127,011	$39,429	$738,889	$313,269	$32,783	$346,052	$0	$1,084,941
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$39	$0	$39	$0	$39
Collectively evaluated for impairment	7,057	739	1,561	79	9,436	3,500	327	3,827	510	13,773
	$7,057	$739	$1,561	$79	$9,436	$3,539	$327	$3,866	$510	$13,812
December 31, 2017										
Loans allocated by:										
Individually evaluated for impairment	$5,848	$492	$350	$0	$6,690	$4,325	$11	$4,336	$0	$11,026
Collectively evaluated for impairment	487,068	30,489	115,313	42,065	674,935	302,160	21,891	324,051	0	998,986
	$492,916	$30,981	$115,663	$42,065	$681,625	$306,485	$21,902	$328,387	$0	$1,010,012
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$42	$9	$51	$0	$51
Collectively evaluated for impairment	6,763	417	1,446	84	8,710	3,358	202	3,560	475	12,745
	$6,763	$417	$1,446	$84	$8,710	$3,400	$211	$3,611	$475	$12,796

In addition to the specific reserve allocations on impaired loans noted previously, 18 loans, with aggregate outstanding principal balances of $2,452,000, have had cumulative partial charge-offs to the ALL totaling $890,000 at September 30, 2018. As updated appraisals were received on collateral-dependent loans, partial charge-offs were taken to the extent the loans' principal balance exceeded their fair value.

Management believes the allocation of the ALL between the various loan segments adequately reflects the probable incurred credit losses in each portfolio. Management re-evaluates and makes certain enhancements to its methodology used to establish a reserve to better reflect the risks inherent in the different segments of the portfolio, particularly in light of changes in levels of charge-offs with noticeable differences between the different loan segments. Management believes these enhancements to the ALL methodology improve the accuracy of quantifying losses presently incurred in the portfolio. Management charges actual loan losses to the reserve and bases the provision for loan losses on the overall analysis taking the methodology into account.

The unallocated portion of the ALL reflects estimated probable incurred losses within the portfolio that have not been identified to specific loans or portfolio segments due to risk of error in the specific and general reserve allocation; other potential exposure in the loan portfolio; variances in management's assessment of national and local economic conditions; and other factors management believes appropriate at the time. The unallocated portion of the ALL totaled $510,000, or 3.7% of the ALL balance, at September 30, 2018 compared with $475,000, or 3.7% of the ALL balance at December 31, 2017.

While management believes the Company's ALL is adequate based on information currently available, future adjustments to the reserve and enhancements to the methodology may be necessary due to changes in economic conditions, regulatory guidance, or management's assumptions as to future delinquencies or loss rates.

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Deposits

Deposits totaled $1,429,170,000 at September 30, 2018, an increase of $209,655,000, or 17.2%, from $1,219,515,000 at December 31, 2017.

Noninterest-bearing deposits increased $25,378,000, or 15.6%, from December 31, 2017 to September 30, 2018 and totaled $187,721,000 at September 30, 2018. Interest-bearing deposits totaled $1,241,449,000 at September 30, 2018, an increase of $184,277,000, or 17.4% from the $1,057,172,000 balance at December 31, 2017. Approximately $58,000,000 of the growth in interest-bearing deposits occurred as certain larger depository relationships, previously enrolled in the Company's repurchase agreement program included in short-term borrowings, transitioned to interest-bearing deposits in a program provided through a third party which provides full FDIC insurance on deposit amounts by exchanging or reciprocating larger depository relationships with other member banks.

The Company has continued to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings delivered by its expanded sales force as it increases its commercial relationships. Deposit growth in the first nine months of 2018 was principally used to fund growth in the loan and investment portfolios, and to reduce total borrowings.

Shareholders' Equity, Capital Adequacy and Regulatory Matters

The management of capital in a regulated financial services company must properly balance return on equity to its shareholders while maintaining sufficient levels of capital and related risk-based regulatory capital ratios to satisfy statutory regulatory requirements. The Company’s capital management strategies have historically been developed to provide attractive rates of returns to its shareholders, while maintaining a “well capitalized” position as defined by our regulators.

Shareholders’ equity totaled $145,557,000 at September 30, 2018, and increased $792,000 or 0.5%, from $144,765,000 at December 31, 2017. Significant factors in this change were net income totaling $11,653,000 for the nine months ended September 30, 2018, offset by a decrease in net unrealized gains/losses in AOCI, net of taxes, totaling $8,317,000 and by dividends paid on common stock totaling $3,166,000.

Capital Adequacy. The Company routinely evaluates its capital levels in light of its risk profile to assess its capital needs. The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Effective with the third quarter of 2018, the FRB raised the consolidated asset limit on small bank holding companies from $1,000,000,000 to $3,000,000,000 and a company with assets under the revised limit is not subject to the FRB consolidated capital rules. A company with consolidated assets under the revised limit may continue to file reports that include capital amounts and ratios. The Company has elected to continue to file those reports.

At September 30, 2018 and December 31, 2017, the Bank was considered well capitalized under applicable banking regulations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. Although applicable to the Bank, prompt corrective action provisions are not applicable to bank holding companies, including financial holding companies.

Note 7, Shareholders' Equity and Regulatory Capital, to the Notes to Consolidated Financial Statements under Part I, Item 1, "Financial Information," includes a table presenting capital amounts and ratios for the Company and the Bank at September 30, 2018 and December 31, 2017.

In addition to the minimum capital ratio requirement and minimum capital ratio to be well capitalized presented in the referenced table in Note 7, the Bank must maintain a capital conservation buffer as more fully described in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, Item 1 - Business, under the topic Basel III Capital Rules. At September 30, 2018, the Bank's capital conservation buffer, based on the most restrictive Total Capital to risk weighted assets capital ratio, was 5.2%, which is above the phase in requirement of 1.875% for December 31, 2018.

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Liquidity
The primary functions of asset/liability management are to ensure adequate liquidity and manage the Company's sensitivity to changing interest rates. Liquidity management involves our ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds are deposit inflows, loan repayments, maturities and sales of investment securities, the sale of mortgage loans and borrowings from the FHLB of Pittsburgh. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.
We regularly adjust our investments in liquid assets based upon our assessment of expected loan demand, expected deposit flows, yields available on interest-earning deposits and securities and the objectives of our asset/liability management policy.
Merger and Acquisitions

See Note 2, Mergers and Acquisitions, to the Consolidated Financial Statements under Part I, Item 1, "Financial Statements" in this Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk
Market risk comprises exposure to interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks. For domestic banks, including the Company, the majority of market risk is related to interest rate risk. Interest rate sensitivity management requires the maintenance of an appropriate balance between reward, in the form of net interest margin, and risk as measured by the amount of earnings and value at risk.
Interest Rate Risk
Interest rate risk is the exposure to fluctuations in the Company's future earnings (earnings at risk) and value (value at risk) resulting from changes in interest rates. This exposure results from differences between the amounts of interest-earning assets and interest-bearing liabilities that reprice within a specified time period as a result of scheduled maturities, scheduled and unscheduled repayments, the propensity of borrowers and depositors to react to changes in their economic interests, and security and contractual interest rate changes.
Management attempts to manage the level of repricing and maturity mismatch through its asset/liability management process so that fluctuations in net interest income are maintained within policy limits across a range of market conditions while satisfying liquidity and capital requirements. Management recognizes that a certain amount of interest rate risk is inherent, appropriate and necessary to ensure the Company's profitability. Thus, the goal of interest rate risk management is to evaluate the amount of reward for taking risk and adjusting both the size and composition of the balance sheet relative to the level of reward available for taking risk.
Management endeavors to control the exposure to changes in interest rates by understanding, reviewing and making decisions based on its risk position. The Company primarily uses its securities portfolio, FHLB advances and brokered deposits to manage its interest rate risk position. Additionally, pricing, promotion and product development activities are directed in an effort to emphasize the loan and deposit term or repricing characteristics that best meet current interest rate risk objectives. We do not currently use hedging instruments for risk management, but we do evaluate them and may use them in the future.
The asset/liability committee operates under management policies, approved by the Board of Directors, which define guidelines and limits on the level of risk.
The Company uses simulation analysis to assess earnings at risk and net present value analysis to assess value at risk. These methods allow management to regularly monitor both the direction and magnitude of the Company's interest rate risk exposure. These modeling techniques involve assumptions and estimates that inherently cannot be measured with complete precision. Key assumptions in the analyses include maturity and repricing characteristics of assets and liabilities, prepayments on amortizing assets, non-maturity deposit sensitivity, and loan and deposit pricing. These assumptions are inherently uncertain due to the timing, magnitude and frequency of rate changes and changes in market conditions and management strategies, among other factors. However, the analyses are useful in quantifying risk and providing a relative gauge of the Company's interest rate risk position over time.

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Earnings at Risk

Simulation analysis evaluates the effect of upward and downward changes in market interest rates on future net interest income. The analysis involves changing the interest rates used in determining net interest income over the next twelve months. The resulting percentage change in net interest income in various rate scenarios is an indication of the Company's short-term interest rate risk. The analysis assumes recent trends in new loan and deposit volumes will continue while the amount of investment securities remains constant. Additional assumptions are applied to modify volumes and pricing under the various rate scenarios. These include prepayment assumptions on mortgage assets, sensitivity of non-maturity deposit rates, and other factors deemed significant.

The simulation analysis results are presented in the Earnings at Risk table below. At September 30, 2018, similar to at December 31, 2017, these results indicate the Company would be better positioned in a moderately rising interest rate environment than it would be if interest rates increased more substantially or decreased.

Value at Risk

Net present value analysis provides information on the risk inherent in the balance sheet that might not be taken into account in the simulation analysis due to the short time horizon used in that analysis. The net present value of the balance sheet is defined as the discounted present value of expected asset cash flows minus the discounted present value of the expected liability cash flows. The analysis involves changing the interest rates used in determining the expected cash flows and in discounting the cash flows. The resulting percentage change in net present value in various rate scenarios is an indication of the longer term repricing risk and options embedded in the balance sheet.

The net present value analysis results are presented in the Value at Risk table below. At September 30, 2018, similar to at December 31, 2017, these results indicate the Company would be better positioned in a moderately rising interest rate environment than it would be if interest rates increased more substantially or decreased.

Earnings at Risk			Value at Risk		
	% Change in Net Interest Income			% Change in Market Value	
Change in Market Interest Rates (basis points)	September 30, 2018	December 31, 2017	Change in Market Interest Rates (basis points)	September 30, 2018	December 31, 2017
(100)	(2.3%)	(6.5 %)	(100)	(8.6%)	(7.2 %)
100	(0.9%)	(1.3 %)	100	2.5 %	(1.8 %)
200	(2.8%)	(4.9 %)	200	1.1 %	(5.4 %)

Item 4. Controls and Procedures

Based on the evaluation required by Securities Exchange Act Rules 13a-15(b) and 15d-15(b), the Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures, as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e), at September 30, 2018. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective at September 30, 2018. There have been no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting during the third quarter of 2018.

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PART II – OTHER INFORMATION
Item 1 – Legal Proceedings
Information regarding legal proceedings is included in Note 12, Contingencies, to the Consolidated Financial Statements under Part I, Item 1, "Financial Statements" and incorporated herein by reference.
Item 1A – Risk Factors
In addition to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, investors should consider the following:
There is no assurance when or even if our acquisition of Hamilton Bancorp, Inc. will be completed.
The merger agreement between the Company and Hamilton is subject to a number of conditions which must be fulfilled in order to complete the merger. Those conditions include:

- approval of the merger agreement and the merger by Hamilton shareholders;
- the receipt of required regulatory approvals;
- absence of orders prohibiting the completion of the merger;
- effectiveness of the registration statement filed by the Company to register the shares of our common stock to be issued to Hamilton shareholders in the merger;
- the continued accuracy of the representations and warranties by both parties and the performance by both parties of their covenants and agreements; and
- the receipt by both parties of legal opinions from their respective tax counsels.

There can be no assurance that the parties will be able to satisfy the closing conditions or that closing conditions beyond their control will be satisfied or waived.
The Hamilton merger agreement may be terminated in accordance with its terms and the merger may not be completed.
The parties can agree at any time to terminate the merger agreement under specified circumstances. In addition, Hamilton may choose to terminate the merger agreement if the volume weighted average stock price of our common stock as reported on NASDAQ during the 15 trading day period immediately preceding the determination date (as defined in the merger agreement) is less than $20.1535 per share and our common stock underperforms the NASDAQ Bank Index by more than 15% between October 23, 2018 and the determination date. Any such termination would be subject to the right of the Company to increase the amount of our common stock or cash consideration to be provided to Hamilton shareholders pursuant to the formulas prescribed in the merger agreement.
Regulatory approvals may not be received or may take longer than expected in order to be obtained for the Hamilton merger.
We are required to obtain the approvals of the Board of Governors of the Federal Reserve System, the Pennsylvania Department of Banking and Securities, and the Maryland Office of the Commissioner of Financial Regulation prior to completing the merger. Obtaining the approval of these regulatory agencies may delay the date of completion of the merger. In addition, you should be aware that, as in any transaction, it is possible that, among other things, restrictions on the combined operations of the two companies may be sought by governmental agencies as a condition to obtaining the required regulatory approvals. This may diminish the benefits of the merger to us or have an adverse effect on us following the merger and prevent us from achieving the expected benefits of the merger. We have the right to terminate the merger agreement if the approval of any governmental authority required for consummation of the merger and the other transactions provided for in the merger agreement, imposes any term, condition or restriction upon us or any of our subsidiaries that we reasonably determine would (a) prohibit or materially limit the ownership or operation by us of any material portion of Hamilton's business or assets, (b) compel us to dispose or hold separate any material portion of Hamilton's assets or (c) compel us to take any action, or commit to take any action, or agree to any condition or request, if the prohibition, limitation, condition or other requirement described in clauses (a)-(c) of this sentence would have a material adverse effect on the future operation by us of our business, taken as a whole.

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If the Hamilton merger is not completed, we will have incurred substantial expenses without realizing the expected benefits.

We will incur substantial expenses in connection with the pending acquisition of Hamilton. If the merger is not completed, these expenses may have a material adverse impact on our operating results.

Goodwill incurred in the Mercersburg and Hamilton mergers may negatively affect our financial condition.

To the extent that the merger consideration, consisting of the cash and the number of shares of our common stock issued in the Mercersburg merger or to be issued in the Hamilton merger, exceeds the fair value of the net assets acquired, including identifiable intangibles, that amount will be reported as goodwill by us. In accordance with current accounting guidance, goodwill will not be amortized but will be evaluated for impairment annually or more frequently if events or circumstances warrant. A failure to realize expected benefits of the merger could adversely impact the carrying value of the goodwill recognized in the merger and, in turn, negatively affect our financial results.

We may be unable to successfully integrate Mercersburg’s and Hamilton's operations.

The mergers involve the integration of companies that previously operated independently with Orrstown. The difficulties of combining the companies’ operations include:

- integrating personnel with diverse business backgrounds;
- integrating departments, systems, operating procedures and information technologies;
- combining different corporate cultures;
- retaining existing customers and attracting new customers; and
- retaining key employees.

The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of one or more of the combined company’s businesses and the loss of key personnel. The diversion of management’s attention and any delays or difficulties encountered in connection with the merger and the integration of the two companies’ operations could have a material adverse effect on the business and results of operations of the combined company.

The success of the mergers will depend, in part, on our ability to realize the anticipated benefits and cost savings from combining the business of the Company with Mercersburg and Hamilton. If we are unable to successfully integrate Mercersburg or Hamilton, the anticipated benefits and cost savings of the mergers may not be realized fully or may take longer to realize than expected. For example, we may fail to realize the anticipated increase in earnings and cost savings anticipated to be derived from the acquisitions. In addition, as with regard to any merger, a significant change in interest rates or economic conditions or decline in asset valuations may also cause us not to realize expected benefits and result in the mergers not being as accretive as expected.

Unanticipated costs relating to the mergers could reduce our future earnings per share.

We believe that we have reasonably estimated the likely costs of integrating the operations of the Company and Mercersburg and Hamilton, and the incremental costs of operating as a combined company. However, it is possible that we could incur unexpected transaction costs such as taxes, fees or professional expenses or unexpected future operating expenses such as increased personnel costs or increased taxes, which could result in the mergers not being as accretive as expected or having a dilutive effect on the combined company’s earnings per share.

The market price of our common stock after the mergers may be affected by factors different from those affecting our shares currently.

The businesses of the Company and Mercersburg and Hamilton differ and, accordingly, the results of operations of the combined company and the market price of the combined company’s shares of common stock may be affected by factors different from those currently affecting the independent results of operations and market prices of common stock of each of us, Mercersburg and Hamilton. The market value of our common stock fluctuates based upon various factors, including changes in our business, operations or prospects, market assessments of the merger, regulatory considerations, market and economic considerations, and other factors. Further, the market price of our common stock after the merger may be affected by factors different from those currently affecting our common stock.

An interruption or breach in security with respect to our information systems, 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.

Information systems are critical to our business. We use various technological systems to manage our customer relationships, general ledger, securities investments, deposits and loans. We rely on software, communication, and information

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exchange on a variety of computing platforms and networks and over the internet. We have established policies and procedures to prevent or limit the effect of system failures, business interruptions and security breaches, but we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. In addition, any compromise of our systems could deter customers from using our products and services. Although we rely on security systems to provide security and authentication necessary to effect the secure transmission of data, these precautions may not protect our systems from security breaches.

We rely on the services of a variety of vendors to meet our data processing and communication needs. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

Two employees of Orrstown Bank, Orrstown Financial Services, Inc.'s wholly-owned banking subsidiary, recently were the victims of an email phishing incident that compromised their email credentials. Orrstown Bank did not make any fraudulent payments as a result of the incident and, as of the date of this report, Orrstown Bank does not believe that any amounts have been withdrawn from customer accounts without authorization or that any customers have experienced identity theft as a result of the incident. Orrstown Bank has no evidence that the unauthorized access to the email accounts otherwise compromised the integrity of the Orrstown Bank platform, which undergoes rigorous annual auditing as well as penetration testing by an outside security firm. Nevertheless, if information security is breached or other technology difficulties or failures occur in the future, 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.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

No shares of the Company were repurchased from July 1, 2018 to September 30, 2018.

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time. At September 30, 2018, 82,725 shares had been repurchased under the program at a total cost of $1,438,000, or 17.38 per share. The maximum number of shares that may yet be purchased under the plan is 333,275 at September 30, 2018.

Item 3 – Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosures

Not applicable.

Item 5 – Other Information

None.

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Item 6 – Exhibits

2.1	Agreement and Plan of Merger, incorporated by reference to Exhibit 2.1 to the Registrant's Report on Form 8-K filed June 1, 2018.
3.1	Articles of Incorporation as amended, incorporated by reference to Exhibit 3.1 of the Registrant’s Report on Form 8-K filed on January 29, 2010.
3.2	By-laws as amended, incorporated by reference to Exhibit 3.2 to the Registrant’s Report on Form 8-K filed January 30, 2018.
4.1	Specimen Common Stock Certificate, incorporated by reference to the Registrant’s Registration Statement on Form S-3 filed February 8, 2010 (File No. 333-164780).
31.1	Rule 13a – 14(a)/15d-14(a) Certification (Principal Executive Officer)
31.2	Rule 13a – 14(a)/15d-14(a) Certifications (Principal Financial Officer)
32.1	Section 1350 Certifications (Principal Executive Officer)
32.2	Section 1350 Certifications (Principal Financial Officer)
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase

All other exhibits for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

/s/ Thomas R. Quinn, Jr.
Thomas R. Quinn, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

/s/ David P. Boyle
David P. Boyle
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: November 6, 2018