FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 09, 2016
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, 2015

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

(717) 264-6116

(Registrant's telephone number, including area code)

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

NONE

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

Common Stock, par value $1.00 per share

(Title of class)

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes No

The aggregate market value of the 3,957,818 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2015 based on the price of such shares was $97,164,432.

There were 4,289,124 outstanding shares of the Registrant's common stock as of February 29, 2016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2015, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

FORM 10-K

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Part I

Item 1. Business

General

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

The Corporation's common stock is thinly traded in the over-the-counter market. The Corporation's stock is listed under the symbol "FRAF" www.otcmarkets.com/stock/FRAF/quote) on the OTCQX Market Tier of the OTC Markets. The Corporation's Internet address is www.franklinfin.com. Electronic copies of the Corporation's 2015 Annual Report on Form 10-K are available free of charge by visiting the "Investor Information" section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

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

F&M Trust is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Bank's business is seasonal. The Bank's lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans, installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations.

The Bank classifies loans in this report by the type of collateral, primarily residential or commercial and agricultural real estate. Loans secured by residential real estate loans may be further broken down into consumer or commercial purpose. Consumer purpose residential real estate loans represent traditional residential mortgages and home equity products. Both of these products are underwritten in generally the same manner; however, home equity products may present greater risk since many of these loans are secured by a second lien position where the Bank may or may not hold the first lien position. Commercial purpose residential real estate loans represent loans made to businesses, but are secured by residential real estate. These loans are underwritten as commercial loans and the repayment ability

may be dependent on the business operation, despite the residential collateral. In addition to the real estate collateral, it is possible that personal guarantees or UCC filings on business assets provide additional security. In certain situations, the Bank acquires properties through foreclosure on delinquent loans. The Bank initially records these properties at the estimated fair value less cost to sell with subsequent adjustments to fair value recorded as needed.

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

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

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for repayment and are generally secured by business assets and personal guarantees. As such, this collateral may be more difficult to sell

in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

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

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

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are 24 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors with only an Internet site are present in the market. The Bank has 22 community offices and approximately 11% of the total deposits in its market. The majority of the Bank's loan and deposit customers are in Franklin County. There are 6 commercial bank competitors in Franklin County and the Bank has approximately 31% of the Franklin County deposit market share. The Bank's approximate deposit market share in other counties is: Fulton (35%), Cumberland (3%) and Huntingdon (2%).

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have declined and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors have access to resources (e.g., financial and technological) that are unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product, service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $1.036 billion on December 31, 2015.

Staff

As of December 31, 2015, the Corporation and its banking subsidiary had 250 full-time equivalent employees. The officers of the Corporation are employees of the Bank. The Bank offers a 401(k) plan, employee stock purchase plans and incentive compensation plans and employees are also provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

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

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a "financial holding company." Financial holding companies are bank holding companies that meet certain minimum capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis; see further discussion below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its Bank subsidiary during periods of financial stress or adversity. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

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

entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking and Securities.

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

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

Community Reinvestment Act

The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act (CRA), assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank’s present CRA rating is “satisfactory.” Various consumer laws and regulations also affect the operations of the Bank.

Capital Adequacy Guidelines

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

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier1 (CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3)Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.125%, increasing each year until fully implemented in 2019 at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of December 31, 2015, the Bank was “well capitalized’ under the Basel III requirements and believes it would be “well capitalized” on a fully-phased in basis had such a requirement been in effect. The minimum capital ratios (shown as “adequately capitalized”) and the “well capitalized” capital ratios are reported in Note 2 of the accompanying financial statements.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a "well capitalized" institution as "adequately capitalized" or require an "adequately capitalized" or "undercapitalized" institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2015, the Corporation and the Bank each satisfied the criteria to be classified as "well capitalized" within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The

Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks that are not classified as well capitalized or adequately capitalized may not pay dividends.

Volker Rule

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

Consumer Laws and Regulations

In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act and the Federal Trade Commission Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations.

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau ("CFPB") was created under the Dodd-Frank Act to centralize responsibility for consumer financial protection with broad rulemaking, supervision, and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts, including the Equal Credit Opportunity Act, Truth in Lending Act ("TILA"), Real Estate Settlement Procedures Act ("RESPA"), Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statues. It is likely that future CFPB rulemaking action will affect the Bank. Banks with total assets less than $10 billion are not subject to examination by the CFPB. However, the CFPB can require any bank to submit reports it deems necessary to fulfill its mission.

Ability to Repay / Qualified Mortgages

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

Commercial Real Estate Guidance

In December 2015, the federal banking agencies released a "Statement on Prudent Risk Management for Commercial Real Estate Lending" (the "CRE Statement"). The agencies stated that financial institutions should review their policies and practices related to CRE lending and should maintain risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk, including maintaining underwriting discipline and

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

Pennsylvania Regulation and Supervision

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

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of $250,000 for each separately insured depositor. The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2015, the Bank was in risk category 1 and its assessment rate was approximately 7 basis points of the assessment base. Dodd-Frank established a new minimum DIF ratio set at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020 and its efforts to achieve this ratio could greatly influence future premium rates.

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

In addition to the FDIC assessments, the Financing Corporation (“FICO”) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature from 2017 to 2019. The Bank’s FICO assessment was approximately $54 thousand in 2015 and was included in FDIC insurance expense.

New Legislation

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

Selected Statistical Information

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

Item 1A. Risk Factors

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

Risk Factors Relating to the Corporation

A focus on real estate related loans may increase the risk of substantial credit losses.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2015, approximately 71% of its loans were secured by real estate. Loans secured by real estate and the percent of the loan portfolio are reported in Table 15. These real estate loans are located primarily in the Bank’s market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. If a loan becomes delinquent as the result of an

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

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

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

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

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

The Bank's lending limit is approximately $17.3 million. Accordingly, the size of the loans that can be offered to customers is less than the size of loans that many of our competitors, with larger lending limits, can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank's primary market areas.

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

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

The Bank's profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Recently, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressure. Interest rates are highly sensitive to many factors that are beyond the Bank's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank's ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk.

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

We rely heavily on communications and information systems to conduct our business. These systems include both our internal network and data systems, as well as those of third party vendors. Any failure, interruption or breach in security or these systems, including a cyber-attack, could result in the disclosure or misuse of confidential or proprietary information. While we have systems, policies and procedures designed to prevent or limit the effect of the

failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of client business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

Risk Factors Relating to the Common Stock

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

There is currently only a limited public market for the Corporation's common stock. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote). Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares. The Corporation currently has no plans to apply to have its common stock listed for trading on any stock exchange or the NASDAQ market.

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

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank's cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible; depending upon the Bank's financial condition and other factors, that the Bank's regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

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

Property	Owned	Leased
Community Banking Facilities	16	7
Remote ATM Sites	3	6
Other Properties	4	2

Included in Other Properties are two properties used for operational support service for the Bank, three offices that were closed as part of a branch consolidation in January 2015 and one other property leased for future use. Of the three offices closed in 2015, two are listed for sale and the third is a leased property with the lease expiring in 2016.

Item 3. Legal Proceedings

The nature of our business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in Management's opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material. In addition, no material proceedings are pending nor are known to be threatened or contemplated against us by governmental authorities.

Item 4. Mine Safety Disclosures

Not Applicable

Part II

Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Market and Dividend Information

The Corporation's common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote). The range of high and low prices is shown in the following table for the years 2015 and 2014, as well as cash dividends declared for those periods. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2015 was $23.50. The Corporation had 1,901 shareholders of record as of December 31, 2015.

Market and Dividend Information

	2015			2014		
(Dollars per share)			Dividends			Dividends
	High	Low	Declared	High	Low	Declared
First quarter	$ 24.05	$ 21.00	$ 0.17	$ 18.75	$ 17.00	$ 0.17
Second quarter	26.01	23.00	0.19	20.25	17.75	0.17
Third quarter	24.60	21.50	0.19	21.75	19.26	0.17
Fourth quarter	24.50	22.90	0.19	23.50	20.50	0.17
			$ 0.74			$ 0.68

Restrictions on the Payment of Dividends

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

Securities Authorized for Issuance under Equity Compensation Plans

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading " Executive Compensation – Compensation Tables" in the Corporation's Proxy Statement for the 2016 Annual Meeting of Shareholders.

Common Stock Repurchases

The Corporation frequently authorizes the repurchase of its common stock through a stock repurchase plan. There was no stock repurchase plan in place during 2015 under an approved repurchase plan. The common shares of the Corporation are purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits, employee benefit and executive compensation plans, and the dividend reinvestment plan. The Corporation did not repurchase any shares in 2015 or 2014.

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Performance Graph

The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ – Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business), the SNL Northeast OTC-BB and Pink Banks Index, the SNL Mid-Atlantic Bank Index, and the SNL Mid-Atlantic Bank $1 billion - $2 billion asset size Index for the five year period ended December 31, 2015, in each case assuming an initial investment of $100 on December 31, 2010 and the reinvestment of all dividends. The Corporation believes that the two SNL Mid-Atlantic Bank Indexes represent a more appropriate peer group due to location and asset size than does the Northeast OTC-BB and Pink Banks Index. Accordingly, the Northeast OTC-BB and Pink Banks Index will be discontinued as a comparative index in the 2016 report.

	Period Ending					
Index	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Franklin Financial Services Corporation	$ 100.00	$ 72.00	$ 86.24	$ 109.90	$ 146.51	$ 161.48
NASDAQ Composite	$ 100.00	$ 99.21	$ 116.82	$ 163.75	$ 188.03	$ 201.40
SNL Northeast OTC-BB & Pink Banks	$ 100.00	$ 97.89	$ 112.76	$ 133.11	$ 152.60	$ 161.17
SNL Mid-Atlantic Bank	$ 100.00	$ 75.13	$ 100.64	$ 135.65	$ 147.79	$ 153.33
SNL Mid-Atlantic Bank $1B - $2B	$ 100.00	$ 91.79	$ 107.73	$ 143.97	$ 155.10	$ 159.13

Shareholders' Information

Dividend Reinvestment Plan:

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

Dividend Direct Deposit Program:

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

Annual Meeting:

The Annual Shareholders' Meeting will be held on Tuesday, April 26, 2016, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, PA. The Business Meeting will begin at 9:00 a.m. with breakfast provided.

Websites:

Franklin Financial Services Corporation: www.franklinfin.com

Farmers & Merchants Trust Company: www.fmtrustonline.com

Stock Information:

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

Registrar and Transfer Agent:

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

Item 6. Selected Financial Data

	Summary of Selected Financial Data for the Year Ended December 31				
	2015	2014	2013	2012	2011
(Dollars in thousands, except per share)					
Summary of Operations					
Interest income	$ 34,615	$ 34,794	$ 36,042	$ 39,142	$ 41,791
Interest expense	2,371	3,180	4,378	6,890	9,154
Net interest income	32,244	31,614	31,664	32,252	32,637
Provision for loan losses	1,285	764	2,920	5,225	7,524
Net interest income after provision for loan losses	30,959	30,850	28,744	27,027	25,113
Noninterest income	12,652	11,131	10,033	9,883	10,200
Noninterest expense	31,136	31,573	31,250	31,033	28,333
Income before income taxes	12,475	10,408	7,527	5,877	6,980
Income tax	2,271	2,006	1,295	512	411
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Performance Measurements					
Return on average assets	1.00%	0.83%	0.61%	0.51%	0.66%
Return on average equity	9.52%	8.44%	6.72%	6.00%	7.68%
Return on average tangible assets (1)	1.02%	0.87%	0.64%	0.55%	0.70%
Return on average tangible equity (1)	10.50%	9.72%	7.86%	7.14%	9.30%
Efficiency ratio (1)	67.39%	70.83%	72.01%	70.44%	63.46%
Net interest margin	3.59%	3.56%	3.47%	3.50%	3.73%
Current dividend yield	3.23%	3.09%	3.98%	4.86%	8.74%
Dividend payout ratio	30.76%	33.88%	45.09%	59.09%	65.05%
Shareholders' Value (per common share)					
Diluted earnings per share	$ 2.40	$ 2.00	$ 1.51	$ 1.32	$ 1.66
Basic earnings per share	2.40	2.01	1.51	1.32	1.66
Regular cash dividends paid	0.74	0.68	0.68	0.78	1.08
Book value	26.05	24.54	22.88	22.31	21.67
Tangible book value (1)	23.94	22.36	20.55	19.84	19.04
Market value	23.50	22.00	17.10	14.00	12.35
Market value/book value ratio	90.25%	89.65%	74.74%	62.75%	56.99%
Price/earnings multiple	9.79	11.00	11.32	10.61	7.44
Balance Sheet Highlights					
Total assets	$ 1,035,295	$ 1,001,448	$ 984,587	$ 1,027,363	$ 990,248
Investment securities	159,473	171,751	159,674	133,328	125,301
Loans, net	771,930	717,420	713,711	743,200	756,687
Deposits and customer repurchase agreements	918,512	890,260	869,558	916,649	841,089
Shareholders' equity	111,376	103,521	95,388	91,634	87,182

Safety and Soundness					
Risk-based capital ratio (Total)	16.34%	15.49%	14.24%	12.60%	12.14%
Leverage ratio (Tier 1)	10.59%	9.69%	9.14%	8.29%	8.40%
Common equity ratio (Tier 1)	15.08%	-	-	-	-
Nonperforming loans/gross loans	0.73%	1.74%	3.49%	4.90%	2.94%
Nonperforming assets/total assets	1.18%	1.63%	3.04%	4.10%	2.60%
Allowance for loan losses as a % of loans	1.29%	1.25%	1.34%	1.38%	1.27%
Net charge-offs/average loans	0.04%	0.19%	0.49%	0.60%	0.86%
Trust assets under management (fair value)	$ 586,664	$ 605,796	$ 574,680	$ 520,434	$ 481,536

(1) See the section titled "GAAP versus Non-GAAP Presentation" of the Application of Critical Accounting Policies in Management's Discussion and Analysis of Financial Condition and Results of Operations

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

Application of Critical Accounting Policies:

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

Allowance for Loan Losses – The allowance for loan losses is the estimated amount considered adequate to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, charged against income. In determining the allowance for loan losses, Management makes significant estimates and, accordingly, has identified this policy as probably the most critical for the Corporation.

Management monitors loan performance on a monthly basis and performs a quarterly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to: current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers' actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The analysis has two components, specific and general allocations. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank's historical loan loss experience and other qualitative factors derived from economic and market conditions are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was $10.1 million at December 31, 2015.

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment quarterly to the Credit Risk Oversight Committee of the Board of Directors.

Financial Derivative – As part of its interest rate risk management strategy, the Bank has entered into an interest rate swap agreement. A swap agreement is a contract between two parties to exchange cash flows based upon an underlying notional amount. Under the swap agreement, the Bank pays a fixed rate and receives a variable rate from an unrelated financial institution serving as counter-party to the agreement. The swap is designated as a cash flow hedge and is designed to minimize the variability in cash flows of the Bank's variable rate liabilities attributable to changes in interest rates. The swap in effect converts a portion of a variable rate liability to a fixed rate liability.

The interest rate swap is recorded on the balance sheet at fair value as an asset or liability. To the extent the swap is effective in accomplishing its objective, changes in the fair value are recorded in other comprehensive income. To the extent the swap is not effective, changes in fair value are recorded in interest expense. Cash flow hedges are determined to be highly effective when the Bank achieves offsetting changes in the cash flows of the risk being hedged. The Bank measures the effectiveness of the hedges on a quarterly basis and it has determined the hedges are highly effective. Fair value is heavily dependent upon the market's expectations for interest rates over the remaining term of the swaps. The final swap transaction matured in 2015.

Restricted Stock - Restricted stock, which is carried at cost, consists of stock of the Federal Home Loan Bank of Pittsburgh (FHLB) and Atlantic Community Bankers Bank (ACBB). Management evaluates the restricted stock for

impairment in accordance with ASC Topic 320. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the banks as compared to the capital stock amount for the banks and the length of time this situation has persisted, (2) commitments by the banks to make payments required by law or regulation and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the banks.

Federal Income Taxes – Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance, when in the opinion of Management, it is more likely than not that some portion or all deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the date of enactment. ASC Topic 740 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more-likely-than-not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty

percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. ASC Topic 740, "Income Taxes" also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

Other-Than-Temporary Investment Impairment – Investment securities are written down to their net realizable value when there is impairment in value that is considered to be "other-than-temporary." The determination of whether or not "other-than-temporary" impairment exists is a matter of judgment. Management reviews investment securities regularly for possible impairment that is "other-than-temporary" by analyzing the facts and circumstances of each investment and the expectations for that investment's performance. "Other-than-temporary" impairment in the value of an investment may be indicated by the length of time and the extent to which market value has been less than cost; the financial condition and near term prospects of the issuer; and whether the Corporation has the intent to sell or is likely to be forced to sell the investment prior to any anticipated recovery in market value.

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

(Dollars in thousands, except per share)	For the Year Ended December 31				
	2015	2014	2013	2012	2011
Return on Average Tangible Assets (non-GAAP)					
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Plus intangible amortization (net of tax)	119	341	281	287	294
Net income (non-GAAP)	10,323	8,743	6,513	5,652	6,863
Average assets	1,021,275	1,015,995	1,029,895	1,041,816	991,866
Less average intangible assets	(9,066)	(9,516)	(9,937)	(10,368)	(10,805)
Average assets (non-GAAP)	1,012,209	1,006,479	1,019,958	1,031,448	981,061
Return on average tangible assets (non-GAAP)	1.02%	0.87%	0.64%	0.55%	0.70%
Return on Tangible Equity (non-GAAP)					
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Plus intangible amortization (net of tax)	119	341	281	287	294
Net income (non-GAAP)	10,323	8,743	6,513	5,652	6,863
Average shareholders' equity	107,175	99,512	92,786	89,551	85,572
Less average intangible assets	(9,066)	(9,516)	(9,937)	(10,368)	(10,805)
Average shareholders' equity (non-GAAP)	98,109	89,996	82,849	79,183	74,767

Return on average tangible equity (non-GAAP)	10.52%	9.72%	7.86%	7.14%	9.18%
Tangible Book Value (per share) (non-GAAP)					
Shareholders' equity	$ 111,376	$ 103,521	$ 95,388	$ 91,634	$ 87,182
Less intangible assets	(9,016)	(9,197)	(9,714)	(10,139)	(10,574)
Shareholders' equity (non-GAAP)	102,360	94,324	85,674	81,495	76,608
Shares outstanding (000's)	4,276	4,218	4,169	4,107	4,023
Tangible book value (non-GAAP)	23.94	22.36	20.55	19.84	19.04
Efficiency Ratio					
Noninterest expense	$ 31,136	$ 31,573	$ 31,250	$ 31,033	$ 28,333
Net interest income plus noninterest income	44,896	42,745	41,697	42,085	42,837
Plus tax equivalent adjustment to net interest income	2,023	1,978	1,596	1,683	1,730
Net securities gains (losses), and OTTI	(716)	(260)	42	56	83
Net interest income plus noninterest income	46,203	44,463	43,335	43,824	44,650
Efficiency ratio	67.39%	71.01%	72.11%	70.81%	63.46%

Results of Operations:

Management’s Overview

The following discussion and analysis is intended to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein.

Franklin Financial Services Corporation reported a 21.4% increase in net income for 2015. Net interest income increased $630 thousand over 2014 due to a small increase in earning assets, and an increase in the net interest margin, resulting from a .10% reduction in the cost of interest-bearing deposits. The provision for loan losses increased $521 thousand due to loan growth. Noninterest income increased nearly 14% ($1.5 million) in 2015 compared to 2014, with nearly every category of noninterest income showing an increase. Noninterest income was boosted by two non-recurring events (as discussed later) that increased non-interest income by $899, pre-tax. Noninterest expense declined $437 thousand when compared to 2014. Despite an increase in pre-tax income, the effective tax rate decreased from 2014 due to a $250 reduction of a deferred tax valuation allowance related to a capital loss. Diluted earnings per share increased from $2.00 in 2014 to $2.40 in 2015. The Corporation declared and paid a dividend of $0.74 per share. The balance sheet grew by approximately $34 million fueled by strong loan growth in the second half of 2015, primarily in the commercial loan area. Deposits increased approximately $37 million due primarily to increases in checking accounts. Shareholders’ equity continued to increase during the year from retained earnings and investments from the dividend reinvestment plan. Other key performance measurements are presented in Item 6.

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

Net Interest Income

The most important source of the Corporation’s earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation’s 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2015 versus 2014

Summary: Tax equivalent net interest income increased by only 2% (Table 1) in 2015 compared to 2014. Interest income declined slightly; however, interest expense declined by $809 thousand thereby resulting in a $675 thousand increase in net interest income. A reduction in interest expense and a larger benefit from tax-free income was sufficient to offset the reduction in interest income. Average interest earning assets increased during the year and the yield declined by .05%. Average interest bearing liabilities declined and the cost of these funds fell by .10%. Non-interest bearing balances help increase the net interest margin and the average balance of these accounts increased during 2015. As a result, tax-equivalent net interest income increased $675 thousand and the net interest margin improved to 3.59% from 3.56% in 2014.

Assets: Table 3 shows the average balance and yield on the major asset classes on the Corporation's balance sheet. Total average interest-earning assets increased by approximately $9 million and the yield fell by .05%. The low interest rate environment that continued through 2015 continued to push asset yields down on both new assets and the repricing of existing assets.

Interest bearing balances held by the Corporation declined as money was put into the loan portfolio; however, the yield on these balances increased during 2015 as Bank owned short-term certificates of deposit (with higher rates) made up a greater percentage of the total balance in 2015 than in 2014.

The average balance of the investment portfolio increased slightly. As loan growth improved during the second half of 2015 investment cash-flow was reinvested into the loan portfolio. The Bank purchased $21.7 million of investment securities during 2015, primarily in mortgage-backed and municipal securities, but generated $30.1 million in cash flow from the portfolio. The yield on the portfolio declined by .08% year-over-year.

The average balance of the loan portfolio increased by approximately $15 million during 2015 as compared to 2014. Commercial loans recorded the largest increase year-over-year. Commercial lending activity picked up in the second half of 2015 and the majority of the commercial loan growth occurred during this time period. The Bank was able to maintain the yield on this portfolio, down only a .03%, compared to a decline of .17% from 2013 to 2014. Residential mortgages declined during the year, but home equity balances increased during the year due primarily to a successful home equity line-of-credit promotion during the year. Consumer loans declined again in 2015 and the Bank does not see this trend changing due to the highly competitive nature and ease of access to these loans from other sources. Approximately 85% of the commercial loan portfolio is variable rate with the majority of these loans tied to

the prime rate. Until there is a significant increase in short-term rates, the yield on the commercial loan portfolio is unlikely to change significantly.

Liabilities: Table 3 shows the average balance and cost of the Bank's interest-bearing liabilities. Average interest-bearing liabilities declined by $14.6 million in 2015. This decline was driven primarily by a $10.8 million decrease in long-term debt as all of the Bank's long-term debt matured in 2014. Time deposits (CDs) declined by approximately $14 million as consumers do not want to lock up their money for longer terms in this low rate environment. Interest-bearing checking increased by approximately $17 million, while the money management product declined by $ 2.8 million. Securities sold under a repurchase agreement was a product that has been discontinued and all accounts have been transitioned to a fully-insured interest-bearing checking product.

Table 2 shows the affect volume and rate had on the change in tax equivalent net interest income in 2015.

2014 versus 2013

Summary: Tax equivalent net interest income increased by only 1% (Table 1) in 2014 compared to 2013. A reduction in interest expense and a larger benefit from tax-free income was sufficient to offset the reduction in interest income. Average interest earning assets (Table 3) declined during 2014 compared to the 2013 average, and the yield on these assets declined slightly by 4 basis points year over year. Likewise, average interest bearing liabilities and the cost of these liabilities declined as compared to 2013. These changes resulted in a $332 thousand increase in tax equivalent net interest income and an improvement in the net interest margin from 3.47% in 2013 to 3.56% in 2014.

Assets: Total average interest-earning assets decreased by $13.0 million and the yield fell from 3.93% in 2013 to 3.89% in 2014. The low interest rate environment that continues to be supported by Federal Reserve actions continues to push asset yields down on both new assets and the repricing of existing assets.

Interest bearing balances held by the Corporation declined as money was put into the investment portfolio; however, the yield on these balances increased during 2014 as Bank owned short-term certificates of deposit (with higher rates) made up a greater percentage of the total balance in 2014 than in 2013.

The average balance of the investment portfolio increased by approximately 12% during 2014 as short-term cash was moved to higher yielding assets. The Bank purchased $41.2 million of securities during 2014, primarily in mortgage-backed and municipal securities. The yield on the portfolio improved by .23% as prepayment on mortgage backed securities slowed.

The average balance of the loan portfolio declined by approximately $5 million for 2014 as compared to the average balance for 2013. Residential mortgage and home equity balances increased during the year, but these increases were

not sufficient enough to offset the decline in commercial and consumer loans. Commercial lending continued to be very competitive in 2014, with a lot of low rate competition seeking out the best customers. The decline in the 2014 average commercial loan portfolio was driven by some accelerated payoffs at the end of 2013 and the beginning of 2014. However, from year-end 2013 to year-end 2014, the commercial loan portfolio increased. The average balance of the mortgage portfolio increased due to more refinancing activity during the year. Home equity production in 2014 was good, and was boosted by a low rate promotion. The average yield on the loan portfolio declined to 4.33% in 2014 from 4.54% in 2013. All categories, except consumer loans, experienced a lower yield in 2014

Liabilities: Table 3 shows the average balance and cost of the major interest-bearing liabilities classes on the Corporation's balance sheet. Average interest-bearing liabilities declined by $33.9 million in 2014. This decline was driven primarily by a $41.5 million decrease in time deposits (CDs). The majority of the decline in CDs was a $23.2 million decrease in brokered CDs from maturities in 2013 that the Bank did not replace. Interest-bearing checking increased by approximately $31 million, fueled in part, by the Bank's action to close its sweep repurchase product and move these accounts to a fully-insured interest-bearing checking product. As CDs mature, the cost of this product continues to decline and this contributed to a 14 basis point reduction in the cost of interest-bearing liabilities in 2014. Securities sold under a repurchase agreement declined for the reason discussed above. Average long-term debt declined slightly, but by the end of 2014, the Bank had paid off all of its long-term debt.

Table 1. Net Interest Income

(Dollars in thousands)	2015	Change $	Change %	2014	Change $	Change %	2013
Interest income	$ 34,615	$ (179)	(0.5)	$ 34,794	$ (1,248)	(3.5)	$ 36,042
Interest expense	2,371	(809)	(25.4)	3,180	(1,198)	(27.4)	4,378
Net interest income	32,244	630	2.0	31,614	(50)	(0.2)	31,664
Tax equivalent adjustment	2,023	45		1,978	382		1,596
Tax equivalent net interest income	$ 34,267	$ 675	2.0	$ 33,592	$ 332	1.0	$ 33,260

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

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

	2015 Compared to 2014			2014 Compared to 2013		
Increase (Decrease) due to:	Increase (Decrease) due to:			Increase (Decrease) due to:		
(Dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	$ (32)	$ 97	$ 65	$ (96)	$ 65	$ (31)
Investment securities:						
Taxable	(148)	(88)	(236)	271	584	855
Nontaxable	373	(231)	142	214	(167)	47
Loans:						
Commercial, industrial and agricultural	535	(157)	378	(351)	(1,001)	(1,352)
Residential mortgage	(83)	(56)	(139)	190	(147)	43
Home equity loans and lines	272	(453)	(181)	23	(364)	(341)
Consumer	(100)	(63)	(163)	(154)	67	(87)
Loans	624	(729)	(105)	(292)	(1,445)	(1,737)
Total net change in interest income	817	(951)	(134)	97	(963)	(866)
Interest expense on:						
Interest-bearing checking	20	8	28	31	41	72
Money management	(12)	(212)	(224)	(2)	(197)	(199)
Savings	3	(2)	1	2	(7)	(5)
Time deposits	(98)	(83)	(181)	(411)	(553)	(964)
Securities sold under agreements to repurchase	(13)	-	(13)	(36)	1	(35)
Short-term borrowings	4	-	4	-	-	-

Long-term debt	(424)	-	(424)	(64)	(3)	(67)
Total net change in interest expense	(520)	(289)	(809)	(480)	(718)	(1,198)
Change in tax equivalent net interest income	$ 1,337	$ (662)	$ 675	$ 577	$ (245)	$ 332

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

Table 3. Analysis of Net Interest Income

	2015			2014			2013		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Averag yield/r
Interest-earning assets:									
Interest-bearing obligations of other banks and federal funds sold	$ 36,732	$ 247	0.67%	$ 43,457	$ 182	0.42%	$ 70,115	$ 213	0.30
Investment securities:									
Taxable	117,973	2,482	2.10%	124,903	2,718	2.18%	110,194	1,863	1.69
Nontaxable	54,854	2,410	4.39%	46,663	2,268	4.86%	42,399	2,221	5.24
Investments	172,827	4,892	2.83%	171,566	4,986	2.91%	152,593	4,084	2.68
Loans:									
Commercial, industrial and agricultural	592,010	24,915	4.21%	579,314	24,537	4.24%	587,359	25,889	4.41
Residential mortgage	80,679	3,270	4.05%	82,706	3,409	4.12%	78,185	3,366	4.31
Home equity loans and lines	65,687	2,921	4.45%	60,099	3,102	5.16%	59,706	3,443	5.77
Consumer	6,196	393	6.34%	7,693	556	7.23%	9,902	643	6.49
Loans	744,572	31,499	4.23%	729,812	31,604	4.33%	735,152	33,341	4.54
Total interest-earning assets	954,131	36,638	3.84%	944,835	36,772	3.89%	957,860	37,638	3.93
Other assets	67,144			71,160			72,035		
Total assets	$ 1,021,275			$ 1,015,995			$ 1,029,895		
Interest-bearing liabilities:									
Deposits:									
	$ 220,314	256	0.12%	$ 203,065	228	0.11%	$ 172,079	156	0.09

Interest-bearing checking									
Money Management	384,499	1,463	0.38%	387,297	1,687	0.44%	387,607	1,886	0.49%
Savings	66,134	49	0.07%	62,603	48	0.08%	60,147	53	0.09%
Time	92,212	599	0.65%	106,391	780	0.73%	147,915	1,744	1.18%
Total interest-bearing deposits	763,159	2,367	0.31%	759,356	2,743	0.36%	767,748	3,839	0.50%
Securities sold under agreements to repurchase	25	-	0.15%	8,539	13	0.15%	32,407	48	0.15%
Short- term borrowings	923	4	0.38%	-	-	-	3	-	0.75%
Long- term debt	-	-	-	10,778	424	3.93%	12,409	491	3.96%
Total interest-bearing liabilities	764,107	2,371	0.31%	778,673	3,180	0.41%	812,567	4,378	0.54%
Noninterest-bearing deposits	143,374			129,748			116,724		
Other liabilities	6,619			8,062			7,818		
Shareholders' equity	107,175			99,512			92,786		
Total liabilities and shareholders' equity	$ 1,021,275			$ 1,015,995			$ 1,029,895		
T/E net interest income/Net interest margin		34,267	3.59%		33,592	3.56%		33,260	3.47%
Tax equivalent adjustment		(2,023)			(1,978)			(1,596)	
Net interest income		$ 32,244			$ 31,614			$ 31,664	

Provision for Loan Losses

For 2015, the Bank recorded net charge-offs of only $310 thousand compared to $1.4 million in 2014. Provision expense was $1.3 million and as a result, the allowance for loan losses (ALL) increased by $975 thousand. The increase in the provision expense was due primarily to an increase in the general allocation as a result of growth in the loan portfolio. At December 31, 2015, the ALL was $10.1 million or 1.29% of total loans compared to $9.1 million and 1.25% of total loans at the end of 2014. While the loan portfolio grew during the year, nonperforming assets declined and Management closely monitors the credit quality of the portfolio in order to ensure that an appropriate ALL is maintained. As part of this process, Management performs a comprehensive analysis of the loan portfolio considering delinquencies trends and events, current economic conditions, and other relevant factors to determine the

adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Loan Quality discussion and Tables 12 -17.

Noninterest Income

The following table presents a comparison of noninterest income for the years ended December 31, 2015 and 2014:

Table 4. Noninterest Income

(Dollars in thousands)	December 31 2015	2014	Change Amount	%
Noninterest Income				
Investment and trust services fees	$ 5,036	$ 4,575	$ 461	10.1
Loan service charges	971	917	54	5.9
Mortgage banking activities	31	37	(6)	(16.2)
Deposit service charges and fees	2,318	2,094	224	10.7
Other service charges and fees	1,239	1,201	38	3.2
Debit card income	1,368	1,320	48	3.6
Increase in cash surrender value of life insurance	551	568	(17)	(3.0)
Net gain from sale of other real estate owned	32	50	(18)	(36.0)
OTTI losses on debt securities	(20)	(20)	-	-
Gain on conversion of investment security	728	-	728	-
Securities gains (losses), net	8	280	(272)	(97.1)
Other	390	109	281	257.8
Total noninterest income	$ 12,652	$ 11,131	$ 1,521	13.7

2015 versus 2014

Investment and Trust Service fees: These fees are comprised of asset management fees, estate administration and settlement fees, employee benefit plans and commissions from the sale of insurance and investment products. Asset management fees are recurring in nature and are affected by the market value of the assets at the time the fees are recognized. Asset management fees increased $359 thousand and estate fees increased $111 thousand over 2014. Commissions from the sale of insurance and investment products decreased by $9 thousand compared to the 2014 commissions. The fair value of trust assets under management decreased to $586.7 million at year-end, compared to $605.8 million at the end of 2014.

Loan service charges: This category includes loan origination fees, offset by those fees that are deferred, as well as production fees for originating mortgages for sale in the secondary market, and any fees for loan services that are charged after origination, e.g.: late fees or debt protection. The primary cause of the increase in 2015 was higher origination fees on commercial and consumer loans, partially offset by lower mortgage origination fees.

Mortgage banking fees: Mortgage banking fees consist primarily of fees for servicing mortgage loans originated and sold by the Bank. The fees for servicing mortgages declined in 2015 as the portfolio of mortgages serviced for others ($21.6 million) continues to pay down. Loans originated for the secondary market are done on a fee basis and these fees are recorded in loan service charges. For loans that were previously sold with servicing retained, mortgage servicing rights (MSR) are recorded and represent the Bank’s rights to receive future fee income from servicing these

loans. In 2015, the MSR amortization, net of impairment charges, was $34 thousand compared to $41 thousand in 2014. While the Bank does not expect to originate and sell mortgages with servicing retained in the future, it will retain the existing servicing portfolio until those loans are paid-off.

Deposit fees: This category is comprised primarily of fees from overdrafts, an overdraft protection program, service charges, and account analysis fees. During 2015, these fees increased $224 thousand compared to 2014. The increase in this category is due primarily to increased enrollment in the Bank's overdraft protection program, resulting in $1.3 million of fees in 2015 compared to $873 thousand in 2014.

Debit card income: Debit card income continues to be one the of best fee generators for the Bank. The Bank expects the upward trend in these fees to continue as more consumers and businesses have and use debit cards. Debit card fees are comprised of both a retail and business card program. The business debit card offers a cash back rewards program based on usage and it continues to grow in popularity. The increase in this category was driven by volume.

Other real estate owned gains (losses), net: This category shows the net gains or losses on the sale of other real estate owned. The gain was generated by the sale of one residential property.

Other: This category includes non-recurring income. The increase in this category is the result of an investment the Corporation owned in an offshore insurance company that liquidated and paid out the investors ($171 thousand) and from a death benefit on a BOLI policy ($103 thousand).

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

The following table presents a comparison of noninterest income for the years ended December 31, 2014 and 2013:

Table 4.1 Noninterest Income

	December 31		Change	
(Dollars in thousands)	2014	2013	Amount	%
Noninterest Income				
Investment and trust services fees	$ 4,575	$ 4,429	$ 146	3.3
Loan service charges	917	879	38	4.3
Mortgage banking activities	37	47	(10)	(21.3)
Deposit service charges and fees	2,094	1,831	263	14.4
Other service charges and fees	1,201	907	294	32.4
Debit card income	1,320	1,236	84	6.8
Increase in cash surrender value of life insurance	568	605	(37)	(6.1)
Net gain (loss) from sale of other real estate owned	50	(99)	149	150.5
OTTI losses on debt securities	(20)	(25)	5	20.0
OTTI losses on equity securities	-	(50)	50	100.0
Securities gains (losses), net	280	33	247	748.5
Other	109	240	(131)	(54.6)
Total noninterest income	$ 11,131	$ 10,033	$ 1,098	10.9

2014 versus 2013

Investment and Trust Service fees: Asset management fees increased $372 thousand, while estate fees decreased $196 thousand over 2013. Commissions from the sale of insurance and investment products decreased by $30 thousand compared to the 2014 commissions. The fair value of trust assets under management increased to $605.8 million at year-end, compared to $574.7 million at the end of 2013.

Loan service charges: The primary cause of the increase in 2014 was higher origination fees on commercial loans, offset by lower mortgage and consumer origination fees.

Mortgage banking fees: The fees for servicing mortgages declined in 2014 as the portfolio of mortgages serviced for others ($29.5 million) continues to pay down. Loans originated for the secondary market are done on a fee basis and these fees are recorded in loan service charges. For loans that were previously sold with servicing retained, mortgage servicing rights (MSR) are recorded and represent the Bank's rights to receive future fee income from servicing these loans. MSR are measured and carried at the lower of cost or market value and are amortized over the expected life of the asset. In 2014, the MSR amortization, net of impairment charges, was $41 thousand compared to $51 thousand in

2013.

Deposit fees: During 2014, the fees increased $263 thousand compared to 2013. The increases in this category are the result of changes made to the Bank's fee schedule in 2014 following a comprehensive review.

Other fees and service charges: This category includes fees for wire transfers, ATM activity fees and safe deposit box rentals. The increases in this category are the result of changes made to the Bank's fee schedule following a comprehensive review.

Debit card and other service charges and fees: Debit card fees are comprised of both a retail and business card program. The business debit card offers a cash back rewards program based on usage. The increase in this category was driven by volume.

Other real estate owned gains (losses), net: This category shows the net gains or losses on the sale of other real estate owned. The losses were generated from the sale of one commercial property and two consumer properties.

Securities gains and losses, and OTTI charges: In 2014, other-than-temporary-impairment (OTTI) charges were recorded on one private label mortgage backed security and three equity securities compared to OTTI on two bonds in 2013. Security gains in 2014 were generated primarily by the sale of equity securities.

Noninterest Expense

The following table presents a comparison of noninterest expense for the years ended December 31, 2015 and 2014:

Table 5. Noninterest Expense

(Dollars in thousands)	December 31		Change	
Noninterest Expense	2015	2014	Amount	%
Salaries and employee benefits	$ 17,186	$ 17,179	$ 7	-
Occupancy, net	2,240	2,359	(119)	(5.0)
Furniture and equipment	924	976	(52)	(5.3)
Advertising	1,105	1,225	(120)	(9.8)
Legal and professional	1,093	1,221	(128)	(10.5)
Data processing	2,051	1,824	227	12.4
Pennsylvania bank shares tax	815	694	121	17.4
Intangible amortization	181	518	(337)	(65.1)
FDIC insurance	663	908	(245)	(27.0)
ATM/debit card processing	830	730	100	13.7
Foreclosed real estate	462	315	147	46.7
Telecommunications	555	488	67	13.7
Other	3,031	3,136	(105)	(3.3)
Total noninterest expense	$ 31,136	$ 31,573	$ (437)	(1.4)

2015 versus 2014

Salaries and benefits: This category is the largest noninterest expense category; however, these expenses increased by only $7 thousand compared to the prior year. Health insurance expense increased $180 thousand, which was offset by a decrease of $93 thousand in salary expense, due to open positions, and a decrease in split dollar plan expenses of $73 thousand. See Note 15 of the accompanying consolidated financial statements for additional information on benefit plans. All other employee benefit expenses remained consistent with 2014 levels.

In October, 2014, the Society of Actuaries released new mortality tables for pension plans. The new tables are expected to raise the assumed life of plan participants due to refinements in age and gender distribution of participants. This change is expected to result in higher pension contribution requirements, lower balance sheet funded status, pricier lump-sum payouts, and higher PBGC variable rate premiums. The Bank has not adopted the new mortality tables for 2015 reporting. If adopted at year-end 2015, it is estimated that the new tables would reduce the funded status by $1.6 million and increase the 2016 pension expense by $272 thousand over the current 2016 estimate.

Net Occupancy: This category includes all of the expense associated with the properties and facilities used for bank operations such as depreciation, leases, maintenance, utilities and real estate taxes. Depreciation expense was down in 2015, as well as less utility and snow removal expense due to a warmer winter than experienced in 2014.

Legal and professional fees: This category consists of fees paid to outside legal counsel, consultants, and audit fees. In total, these fees decreased $128 thousand from 2014. The decreases were primarily in internal audit fees, due to a change in internal audit firms and in consulting fees.

Data processing: The largest cost in this category is the expense associated with the Bank's core processing system and related services, and accounted for $1.1 million of the total data processing costs in 2015 and 2014. The increase in 2015 was due to higher customer utilization of the Bank's various electronic banking products.

FDIC insurance: This category consists of the total fees paid to the Federal Deposit Insurance Corporation. The expense for 2015 decreased compared to prior year as an improvement in the Bank's credit quality reduced the assessment factor.

Other: Other noninterest expense decreased in 2015 due primarily to higher nonrecurring expenses in 2014. The Bank incurred $182 thousand in penalties for prepaying FHLB debt in 2014 compared to none in 2015. The Bank also wrote off $128 thousand in development costs for a potential community office site that was deferred and $83 thousand of furniture and equipment expense in 2014 from the consolidation of three community offices in January 2015. The Bank took one-time expenses to fulfill the funding requirement of a deferred director's benefit plan established thirty years ago ($70 thousand), as well as expenses related to branch assets taken out of service in 2015 ($60 thousand).

The following table presents a comparison of noninterest expense for the years ended December 31, 2014 and 2013:

Table 5.1 Noninterest Expense

(Dollars in thousands)	December 31		Change	
Noninterest Expense	2014	2013	Amount	%
Salaries and employee benefits	$ 17,179	$ 16,590	$ 589	3.6
Occupancy, net	2,359	2,259	100	4.4
Furniture and equipment	976	975	1	0.1
Advertising	1,225	1,384	(159)	(11.5)
Legal and professional	1,221	1,172	49	4.2
Data processing	1,824	1,713	111	6.5
Pennsylvania bank shares tax	694	815	(121)	(14.8)
Intangible amortization	518	425	93	21.9
FDIC insurance	908	979	(71)	(7.3)
ATM/debit card processing	730	706	24	3.4
Foreclosed real estate	315	293	22	7.5
Telecommunications	488	467	21	4.5
Other	3,136	3,472	(336)	(9.7)
Total noninterest expense	$ 31,573	$ 31,250	$ 323	1.0

2014 versus 2013

Salaries and benefits: This category increased $589 thousand as compared to the prior year. Salary expense increased by $578 thousand and employee incentive programs increased $360 thousand during 2014. The increase in salary expense is due primarily to salary adjustments and a severance accrual for employees affected by the consolidation of three community offices in January 2015, while incentive expense increased due to the improvement in financial performance during the year. Offsetting these increases was a reduction in health insurance due to lower claim expense in the Bank’s self-funded plan and a reduction in pension expense of $284 thousand. See Note 15 of the accompanying consolidated financial statements for additional information on benefit plans. All other employee benefit expenses remained consistent with 2013 levels.

Net Occupancy: The increase during 2014 was due to a colder winter with higher expenses for snow removal than experienced in 2013.

Legal and professional fees: In total, these fees remained flat year over year; however, the Bank recorded higher consulting fees that were partially offset by a reduction in legal fees. Internal and external audit fees increased slightly during the year.

Data processing: The largest cost in this category is the expense associated with the Bank’s core processing system and related services, and accounted for $1.1 million of the total data processing costs compared to $1.3 million in 2013. The reduction in core processing costs were related to one time charges for new technology initiatives in 2013.

Other: Other noninterest expense decreased 9.7% in 2014 due primarily to a one-time nonrecurring expense in 2013 of $667 thousand for a deferred compensation plan assumed by the Bank from its 2006 acquisition of Fulton Bancshares Corporation. In 2014, the Bank incurred $182 thousand in penalties for prepaying FHLB debt compared to zero in 2013. The Bank also wrote off $128 thousand in development costs for a potential community office site and $83 thousand of furniture and equipment expense prior to the consolidation of three community offices in January 2015. These increases were offset by decreases in other expenses (down $283 thousand) and loan collection expense (down $103 thousand).

Provision for Income Taxes

The Corporation recorded a Federal income tax expense of $2.3 million in 2015 compared to $2.0 million in 2014 and $1.3 million in 2013. The effective tax rate for 2015, 2014 and 2013 was 18.2%, 19.3% and, 17.2% respectively. During 2015, the Corporation reduced the deferred tax valuation allowance related to capital losses by $200 thousand primarily due to a gain on conversion and sale of equity securities. Without this reduction, the effective tax rate for 2015 would have been 19.8% compared to 19.3% in 2014. For a more comprehensive analysis of Federal income tax expense refer to Note 12 of the accompanying financial statements.

Financial Condition

One method of evaluating the Corporation’s condition is in terms of its sources and uses of funds. Assets represent uses of funds while liabilities represent sources of funds. At December 31, 2015, total assets increased 3.4% over the prior year to $1.035 billion from $1.001 billion at the end of 2014.

Interest Bearing Deposits in Other Banks:

This asset decreased $15.8 million year-over-year, to fund growth in the loan portfolio. Therefore, the average balance for 2015 deceased compared to 2014. At year-end, approximately $17 million was held by other banks in the form of short-term certificates of deposit. Approximately $835 thousand was held in an interest-bearing account at the Federal Reserve.

Investment Securities:

The investment portfolio serves as a mechanism to invest funds if funding sources out pace lending activity, to provide liquidity for lending and operations, and provide collateral for deposits and borrowings. The mix of securities is determined by the Bank’s Investment Committee and investing decisions are made as a component of balance sheet management. Debt securities include U.S. Government Agencies, U.S. Government Agency mortgage-backed securities, non-agency mortgage-backed securities, state and municipal government bonds, corporate debt and trust preferred securities. The equity portfolio consists of one community bank stock. The average life of the portfolio is 4.1 years and $74.1 million (fair value) is pledged as collateral for deposits. The Bank has no investments in a single issuer that exceeds 10% of shareholders equity. All securities are classified as available for sale and all investment balances refer to fair value, unless noted otherwise.

The following table presents amortized cost and estimated fair value of investment securities by type at December 31 for the past three years:

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

	2015		2014		2013	
	Cost	Fair Value	Cost	Fair Value	Cost	Fair Value
(Dollars in thousands)						
Equity securities	$ 164	$ 233	$ 274	$ 1,053	$ 1,472	$ 1,970
U.S. Government and Agency securities	13,705	13,836	15,854	15,963	11,771	11,751
Municipal securities	67,851	69,188	66,832	68,366	56,861	56,857
Corporate debt securities	-	-	-	-	1,002	1,001
Trust preferred securities	5,958	5,289	5,940	5,137	5,922	5,051
Agency mortgage-backed securities	69,284	69,519	78,779	79,494	81,352	81,027
Private-label mortgage-backed securities	1,335	1,372	1,675	1,695	1,984	1,969
Asset-backed securities	38	36	45	43	51	48
	$ 158,335	$ 159,473	$ 169,399	$ 171,751	$ 160,415	$ 159,674

The following table presents analysis of investment securities at December 31, 2015 by maturity, and the weighted average yield for each maturity presented. The yields presented in this table are calculated using tax-equivalent interest and the amortized cost.

Table 7. Maturity Distribution of Investment Portfolio

	One year or less		After one year through five years		After five years through ten years		After ten years		Total	
(Dollars in thousands)	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield
Available for Sale										
U.S. Government and Agency securities	$ -	-	$ 1,128	1.98%	$ 7,664	2.21%	$ 5,044	0.85%	$ 13,836	1.70%
Municipal securities	2,128	5.64%	11,064	4.54%	22,979	4.34%	33,017	3.55%	69,188	4.03%
Trust preferred securities	-	-	-	-	-	-	5,289	1.77%	5,289	1.77%
Agency mortgage-backed securities	1	4.82%	2,418	2.37%	9,286	2.60%	57,814	2.17%	69,519	2.23%
Private-label mortgage-backed securities	-	-	-	-	-	-	1,372	5.37%	1,372	5.37%
Asset-backed securities	27	0.36%	-	-	-	-	9	3.63%	36	0.91%
	$ 2,156	5.57%	$ 14,610	3.98%	$ 39,929	3.53%	$ 102,545	2.57%	$ 159,240	2.98%

Table 3 shows the three-year trend of average balances and yields on the investment portfolio. While the average balance for 2015 remained consistent with the 2014 average, year-over-year ending balances declined (Table 6), due primarily to cash-flow from mortgage-backed securities not being reinvested into the portfolio. The yield on the portfolio declined slightly from 2.91% in 2014 to 2.83% in 2015. U.S. Agency mortgage-backed securities and municipal bonds continue to comprise the largest sectors by fair value of the portfolio, approximately 87% in total. The Bank expects that the portfolio will continue to remain concentrated in these investment sectors. The portfolio produced $32.1 million in cash flows in 2015 while $21.7 million was invested into the portfolio during the year. For the year, the Corporation recorded a gain of $728 thousand on the conversion of a bank equity security as the result of its acquisition by another bank; a gain of $8 thousand from the subsequent sale of this equity; and an other-than-temporary impairment charge of $20 thousand on one private-label mortgage-backed security.

Municipal Bonds: The Bank's municipal bond portfolio is well diversified geographically and is comprised of both tax-exempt (79% of the portfolio) and taxable (21% if the portfolio) municipal bonds. General obligation bonds (74%) and revenue bonds (16%) comprise the largest portions of the portfolio. The portfolio holds 116 issues within 29 states. The largest dollar exposure is to issuers in the state of Texas (fair value of $9.2 million / 17 issues) and Pennsylvania (fair value of $8.6 million / 15 issues). Fifty percent of the portfolio has either private bond insurance or some other type of credit enhancement. When purchasing municipal bonds, the Bank looks primarily to the underlying credit of the issuer as a sign of credit quality and then to any credit enhancement. Approximately $67 million of the portfolio is rated "A" or higher by Moody and the weighted average rating of the portfolio is "Aa2". The Bank owns five issues, within four states, for $2.6 million that are not rated by a nationally recognized rating agency.

Trust Preferred Bonds: The following table provides additional detail about the Bank's trust preferred securities at December 31, 2015. The holdings remain the same as at the prior year end, but the unrealized loss has declined from $803 thousand to $669 thousand year-over-year. The credit ratings for each bond are similar to the ratings one year prior. Trust preferred securities are typically issued by a subsidiary grantor trust of a bank holding company, which uses the proceeds of the equity issuance to purchase deeply subordinated debt issued by the bank holding company. Trust-preferred securities can reflect single entity issues or a group of entities (pooled trust preferred). Pooled trust preferred securities have been the subject of significant write-downs due in some cases from the default of one issuer in the pool that then impairs the entire pool. All of the Bank's issues are single issuer, variable rate notes with long final maturities (2027-2028) that continue to pay dividends as scheduled.

Table 8. Trust Preferred Securities

(Dollars in thousands)

Deal Name	Maturity	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Unrealized Gain (Loss)	Lowest Credit Rating Assigned
BankAmerica Cap III	1/15/2027	Single	Preferred Stock	$ 964	$ 847	$ (117)	BB+
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	278	258	(20)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	943	820	(123)	BB
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	939	859	(80)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	895	785	(110)	BB
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	964	849	(115)	BBB-
Fleet Cap Tr V	12/18/2028	Single		975	871	(104)	BB+

Preferred Stock	$ 5,958	$ 5,289	$ (669)

Mortgage-backed Securities (MBS): This sector holds $70.9 million or 44% of the total portfolio. The majority of this sector ($69.5 million) is comprised of U.S. Government Agency MBS. The Government MBS sector is comprised of mortgage backed securities and collateralized mortgage obligations, both fixed and variable rate. In addition, the Bank holds six private-label mortgage-backed securities (PLMBS) with a fair value of $1.4 million and an amortized cost of $1.3 million.

The Bank's private-label mortgage-backed securities (PLMBS) portfolio is comprised primarily of Alt-A loans. Alt-A loans are first-lien residential mortgages that generally conform to traditional "prime" credit guidelines; however, loan factors such as the loan-to-value ratio, loan documentation, occupancy status or property type cause these loans not to qualify for standard underwriting programs. The Alt-A product in the Bank's portfolio is comprised of fixed-rate mortgages that were originated between 2004 and 2006 and all were originally rated AAA. The bonds issued in 2006 are experiencing the highest delinquency and loss rates. All of these bonds originally had some type of credit support tranche to absorb any loss prior to losses at the senior tranche held by the Bank, but this has eroded completely on some bonds as they have started to experience losses. The Bank recorded other-than-temporary impairment charges of $20 thousand on one PLMBS in 2015. Based on the performance of some of the PLMBS, it appears as if the underwriting standards that were represented in the offering, and resulted in the AAA rating, were not followed. As a result, the Bank purchased some securities based on these misrepresentations, and it is most likely that these securities would not have been purchased had all the information been reported correctly. The following table provides additional detail about the Bank's PLMBS at December 31, 2015.

Table 8.1 Private Label Mortgage Backed Securities

(Dollars in thousands)								
Description	Origination Date	Amortized Cost	Fair Value	Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	$ 1	$ 1	$ -	ALT A	BBB+	11.74	$ -
MALT 2004-6 7A1	6/1/2004	355	363	8	ALT A	CCC	15.05	-
RALI 2005-QS2 A1	2/1/2005	204	217	13	ALT A	CC	5.23	10
RALI 2006-QS4 A2	4/1/2006	469	480	11	ALT A	D	-	313
GSR 2006-5F 2A1	5/1/2006	58	65	7	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	248	246	(2)	ALT A	D	-	217
		$ 1,335	$ 1,372	$ 37				$ 555

Impairment:

Table 9 reflects the temporary impairment in the investment portfolio, aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of December 31, 2015 and 2014.

The condition of the portfolio at year-end 2015, as measured by the dollar amount of temporarily impaired securities is essentially unchanged since year-end 2014. The trust-preferred sector recorded the largest unrealized loss, while the Agency MBS and municipal portfolios contain the greatest number of securities with an unrealized loss.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at December 31, 2015, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

Table 9. Temporary Impairment

	December 31, 2015								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	$ 479	$ (1)	3	$ 4,364	$ (32)	10	$ 4,843	$ (33)	13
Municipal securities	5,806	(35)	8	4,785	(183)	7	10,591	(218)	15
Trust preferred securities	-	-	-	5,289	(669)	7	5,289	(669)	7
Agency mortgage-backed securities	18,977	(215)	29	7,394	(171)	13	26,371	(386)	42
Private-label mortgage-backed securities	-	-	-	246	(2)	1	246	(2)	1
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	$ 25,262	$ (251)	40	$ 22,083	$ (1,059)	39	$ 47,345	$ (1,310)	79

	December 31, 2014								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	$ 4	$ -	1	$ 7,207	$ (64)	14	$ 7,211	$ (64)	15
Municipal securities	5,651	(33)	9	9,441	(259)	14	15,092	(292)	23
Trust preferred securities	-	-	-	5,137	(803)	7	5,137	(803)	7
Agency mortgage-backed securities	9,304	(60)	13	8,199	(157)	10	17,503	(217)	23
Private-label mortgage-backed securities	-	-	-	540	(15)	1	540	(15)	1
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	$ 14,959	$ (93)	23	$ 30,529	$ (1,300)	47	$ 45,488	$ (1,393)	70

The unrealized loss in the trust preferred sector declined by $134 thousand compared to the prior year-end and market prices continued to show some improvement during the year. All of the Bank's trust preferred securities are variable rate notes with long maturities (2027-2028) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program

(TARP), continue to pay dividends and have raised capital. The credit ratings on this portfolio are similar to the prior year and no bonds have missed or suspended any payments. At December 31, 2015, the Bank believes it will be able to collect all interest and principal due on these bonds and that it will not be forced to sell these bonds prior to maturity. Therefore, no other-than-temporary-impairment charges were recorded.

The Agency mortgage-backed securities portfolio had a $169 thousand increase in unrealized losses since the end of 2014. The change in value in this sector is driven by market interest rates since these bonds have essentially no credit risk.

The PLMBS sector continues to show a gross unrealized loss of $2 thousand on one security. The majority of this sector is comprised of "Alt-A" PLMBS. These bonds were all rated AAA at time of purchase but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the Alt-A investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that one bond contained losses that were considered other-than-temporary. Management determined $20 thousand was credit related and therefore, recorded an impairment charge of $20 thousand against earnings in 2015. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. For additional detail on the Bank's PLMBS, see Table 8.1.

The Bank held $782 thousand of restricted stock at the end of 2015 of which $752 thousand is stock in the Federal Home Loan Bank of Pittsburgh (FHLB). FHLB stock is carried at a cost of $100 per share. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support it operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. If FHLB stock were deemed to be impaired, the write-down for the Bank could be significant. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

Loans:

Average gross loans for 2015 increased by $14.8 million to $744.6 million compared to $729.8 million in 2014. Commercial loans and home equity loans and lines of credit showed an increase in average balances during the year, which was offset by a decline in average residential mortgage and consumer loans during the year. The yield on the portfolio declined again in 2015 after another year of low interest rates, dropping to 4.23% in 2015 from 4.33% in 2014. Table 3 presents detail on the 2015 average balances and yields earned on loans for the past three years. The following table shows loans outstanding, by primary collateral, as of December 31 for the past 5 years.

Table 10. Loan Portfolio

(Dollars in thousands)	December 31 2015		2014		2013		2012		2011
	Balance	% Change	Balance	% Change	Balance	% Change	Balance	% Change	Balance
Residential real estate 1-4 family									
Consumer first lien	$ 103,698	(1.3)	$ 105,014	1.4	$ 103,573	10.4	$ 93,790	8.1	$ 86,767
Commercial first lien	57,780	2.6	56,300	(3.7)	58,466	(3.9)	60,809	10.3	55,130
Total first liens	161,478	0.1	161,314	(0.4)	162,039	4.8	154,599	9.0	141,897
Consumer junior lien and lines of credit	44,996	18.0	38,132	10.1	34,636	(2.4)	35,494	(11.9)	40,290
Commercial junior liens and lines of credit	5,917	4.5	5,663	(4.6)	5,939	(12.6)	6,794	(13.4)	7,846
Total junior liens and lines of credit	50,913	16.3	43,795	7.9	40,575	(4.1)	42,288	(12.1)	48,136
Total residential real estate 1-4 family	212,391	3.6	205,109	1.2	202,614	2.9	196,887	3.6	190,033
Residential real estate construction									
Consumer purpose	545	(66.5)	1,627	(58.9)	3,960	21.7	3,255	135.7	1,381
Commercial purpose	7,343	(9.2)	8,088	(5.5)	8,559	(29.7)	12,177	(38.8)	19,901
Total residential real estate construction	7,888	(18.8)	9,715	(22.4)	12,519	(18.9)	15,432	(27.5)	21,282
Commercial real estate	340,695	4.4	326,482	(0.9)	329,373	(9.5)	363,874	1.4	358,974
Commercial	215,942	20.6	179,071	5.1	170,327	2.2	166,734	(8.7)	182,694

Total commercial	556,637	10.1	505,553	1.2	499,700	(5.8)	530,608	(2.0)	541,668
Consumer	5,100	(17.1)	6,154	(28.3)	8,580	(19.5)	10,652	(20.7)	13,427
Total loans	782,016	7.6	726,531	0.4	723,413	(4.0)	753,579	(1.7)	766,410
Less: Allowance for loan losses	(10,086)	10.7	(9,111)	(6.1)	(9,702)	(6.5)	(10,379)	6.7	(9,723)
Net loans	$ 771,930	7.6	$ 717,420	0.5	$ 713,711	(4.0)	$ 743,200	(1.8)	$ 756,687

Residential real estate: This category is comprised of first lien loans and, to a lesser extent, junior liens and lines of credit secured by residential real estate. Total residential real estate loans increased $7.3 million over 2014 as the primarily the result of an increase in consumer junior liens and lines of credit. The Bank's mortgage portfolio held steady during 2015 as any mortgages originated were offset by run-off in the portfolio. In 2015, the Bank originated $18.1 million in mortgages, including approximately $9.1 million for a fee through a third party brokerage agreement. The Bank does not originate or hold any loans that would be considered sub-prime or Alt-A, and does not generally originate mortgages outside of its primary market area. The Bank expects 2016 activity to be primarily purchase money mortgages.

Home equity lending picked up in 2015 and as a result both the ending and average balance of this product increased in 2015. The majority of the home equity production in 2015 was in the line-of-credit product that offers a variable rate and was offered with promotional pricing during the year. However, line-of-credit originations do not always result in a dollar for dollar increase in new balances. Despite low rates, the Bank expects that home equity lending will not pick up significantly in 2016.

Commercial purpose loans in this category represent loans made for various business needs, but are secured with residential real estate. In addition to the real estate collateral, it is possible that additional security is provided by personal guarantees or UCC filings. These loans are underwritten as commercial loans and are not originated to be sold.

Residential real estate construction: The largest component of this category represents loans to residential real estate developers of $7.3 million, while loans for individuals to construct personal residences totaled $545 thousand at December 31, 2015. This category continued to decline again in 2015 as the residential real estate market for new construction is still slow. The Bank's exposure to residential construction loans is concentrated primarily in south central Pennsylvania. Real estate construction loans, including residential real estate and land development loans, occasionally provide an interest reserve in order to assist the developer during the development stage when minimal cash flow is generated. All real estate construction loans are underwritten in the same manner, regardless of the use of an interest reserve. At December 31, 2015, the Bank had $1.5 million in residential real estate construction loans funded with an interest reserve and capitalized $8 thousand of interest from these reserves on active projects. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices or AIA documents of costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds.

Commercial loans: Commercial loans continue to be the largest loan category on the balance sheet and increased 10.1% compared to the end of 2014. In 2015, the Bank approved approximately $242 million in commercial loans and commitments with approximately $188 million in new money advances. Low rates continue to make variable rate loans attractive to borrowers. However, in today's low rate environment, the extremely low rates squeeze loan profitability. The competition for good quality loans continues

to be strong with the best customers able to attract multiple offers. In addition, where the Bank was able to book new loans with rate floors in prior years, the competitive environment has seen the use of rate floors more difficult to obtain. The Bank offers competitive products, but believes it is not always in the best long-term interest of the Bank to match every competitive offer; therefore, it is likely that the Bank will lose some balances due solely to pricing.

Commercial real estate (CRE): This category includes commercial, industrial, farm and agricultural loans, where real estate serves as the primary collateral for the loan. This loan category increased by $14.2 million over the prior year. The increases in 2015 were primarily in construction and land development and multi-family residential loans. The largest sectors (by collateral) in CRE are: office buildings ($45.3 million), hotel and motel ($44.9 million), land development ($42.0 million) and apartment units ($32.4 million).

Commercial (C&I): This category includes commercial, industrial, farm, agricultural, and municipal loans. Collateral for these loans may include business assets or equipment, personal guarantees, or other non-real estate collateral. C&I loans increased $36.9 million over the 2014 ending balance, primarily in tax free municipal loans. At December 31, 2015, the Bank had approximately $81 million of municipal loans in its portfolio. The largest sectors (by industry) are: retail trade ($73.1 million), construction ($53.4 million), accommodation and food services ($50.1 million), utilities ($37.3 million) and agriculture ($36.8 million). The Bank does not have any loan exposure to the oil and gas industry.

The Bank is active in its market in pursuing commercial lending opportunities, but supplements in-market growth with purchased loan participations. The Bank purchases commercial loan participations in an effort to increase its commercial lending and diversify its loan mix, both geographically and by industry sector. Purchased loans are originated primarily within the south central Pennsylvania market and are purchased from only a few select counter parties. These loans usually represent an opportunity to participate in larger credits that are not available in market, with the benefit of lower origination and servicing costs. In 2015, the Bank purchased $44.5 million of loan participations and commitments, approximately $30 million higher than 2014 purchases. At December 31, 2015, the Bank held $123.0 million in purchased loan participations in its portfolio compared to $127.1 million at the prior year-end. When the Bank is not the lead bank in the loan participation, it often sees these loans payoff unexpectedly and with no input from the lead Bank about refinancing options. The Bank expects that commercial lending will continue to be the primary area of loan growth in the future via in-market and loan participation activity.

Consumer loans: This category is comprised of direct installment loans and unsecured personal lines of credit, and continues to show a downward trend in outstanding balances. This category declined by $1.1 million from 2014. With the unwillingness of consumers to increase their debt, and the highly price competitive nature of consumer lending, the consumer portfolio is expected to continue to run-down throughout 2016.

Table 11. Maturities and Interest Rate Terms of Selected Loans

The following table presents the stated maturities (or earlier call dates) of selected loans as of December 31, 2015. Residential mortgage and consumer loans are excluded from the presentation.

(Dollars in thousands)	Less than 1 year	1-5 years	Over 5 years	Total
Loans:				
Residential real estate construction	$ 5,416	$ 1,927	$ 545	$ 7,888
Commercial real estate	31,914	75,387	233,394	340,695
Commercial	57,210	45,664	113,068	215,942
	$ 94,540	$ 122,978	$ 347,007	$ 564,525

Loans with fixed and variable interest rates at December 31, 2015 are shown below:

(Dollars in thousands)	Less than 1 year	1-5 years	Over 5 years	Total
Loans with fixed rates	$ 4,612	$ 41,675	$ 38,207	$ 84,494
Loans with variable rates	89,928	81,303	308,800	480,031
	$ 94,540	$ 122,978	$ 347,007	$ 564,525

Loan Quality:

Management utilizes a risk rating scale ranging from 1 (Prime) to 9 (Loss) to evaluate loan quality. This risk rating scale is used primarily for commercial purpose loans. Consumer purpose loans are identified as either a pass or substandard rating. Substandard consumer loans are loans that are 90 days or more past due and still accruing. Loans rated 1 – 4 are considered pass credits. Loans that are rated 5 are pass credits, but have been identified as credits that are likely to warrant additional attention and monitoring. Loans rated 6 (Special Mention) or worse begin to receive enhanced monitoring and reporting by the Bank. Loans rated 7 (Substandard) or 8 (Doubtful) exhibit the greatest financial weakness and present the greatest possible risk of loss to the Bank. Nonaccrual loans are rated

no better than 7. The following represents some of the factors used in determining the risk rating of a borrower: cash flow, debt coverage, liquidity, management, and collateral. Risk ratings, for pass credits, are generally reviewed annually for term debt and at renewal for revolving or renewing debt. The Bank monitors loan quality by reviewing four measurements: (1) loans rated 6 or worse (collectively “watch list”), (2) delinquent loans, (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank’s internally established targets, as well as its national peer group.

Watch list loans exhibit financial weaknesses that increase the potential risk of default or loss to the Bank. However, inclusion on the watch list, does not by itself, mean a loss is certain. The watch list includes both performing and nonperforming loans. Watch list loans totaled $27.9 million at year-end compared to $40.5 million one year earlier. The watch list is comprised of $10.3 million rated 6-Special Mention, and $17.8 million rated 7-Substandard. Loans rated 7 have declined by $5.0 million since year-end 2014 and $39.8 million since year-end 2013. The Bank has no loans rated 8 (Doubtful) or 9 (Loss). The composition of the watch list loans, by primary collateral, is shown in Note 6 of the accompanying financial statements and includes all those loans rated lower than “pass”. Included in the 2015 substandard loan total is $5.4 million of nonaccrual loans compared to $12.3 million one year earlier. Of the nonaccrual loans, the most significant nonaccrual loans are reported on Table 13. The Bank’s Loan Management Committee reviews these loans and risk ratings on a quarterly basis in order to proactively identify and manage problem loans. In addition, a committee meets monthly to discuss possible workout strategies for OREO and all credits rated 7 or worse. Management also tracks other commercial loan risk measurements including high loan to value loans, concentrations, participations and policy exceptions and reports these to the Credit Risk Oversight Committee of the Board of Directors. The Bank also uses a third-party consultant to assist with internal loan review with a goal of reviewing 60% of commercial loans each year. The FDIC defines certain supervisory loan-to-value lending limits. The Bank’s internal loan–to-value limits are all equal to, or have a lower loan-to-value limit, than the supervisory limits. At December 31, 2015, the Bank had loans of $27.3 million that exceeded the supervisory limit.

Delinquent loans are a result of borrowers’ cash flow and/or alternative sources of cash being insufficient to repay loans. The Bank’s likelihood of collateral liquidation to repay the loans becomes more probable the further behind a borrower falls, particularly when loans reach 90 days or more past due. Management monitors the performance status of loans by the use of an aging report. The aging report can provide an early indicator of loans that may become severely delinquent and possibly result in a loss to the Bank. See Note 6 in the accompanying financial statements for a note that presents the aging of payments in the loan portfolio.

Nonaccruing loans generally represent Management’s determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation may or may not fully repay both interest and principal. It is the Bank’s policy to evaluate the probable collectability of principal and interest due under terms of loan contracts for all loans 90-days or more, nonaccrual loans, or impaired loans. Further, it is the Bank’s policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. Upon determination of nonaccrual status, the Bank subtracts any current year accrued and unpaid interest from its income, and any prior year accrued and unpaid interest from the allowance for loan losses. Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss. Nonaccrual loans are rated no better than 7 (Substandard).

Loan quality has improved for the third straight year during 2015, as measured by the balance of nonperforming loans reported in Table 12. Nonperforming loans have decreased by $6.9 million with the majority of the decrease coming in nonaccrual commercial real estate loans. Table 13 identifies the most significant loans in nonaccrual status. These four nonaccrual loans account for 82% of the total nonaccrual balance. During 2015, the primary changes to the significant nonaccrual list was a payoff of approximately $1.8 million and a $3.0 million loan moved from nonaccrual to other real estate owned. Also included in the nonaccrual total are $2.0 million of loans classified as troubled debt restructurings (TDR), including credit 2 on Table 13. A TDR loan is maintained on nonaccrual status until a

satisfactory repayment history is established. All loans on the watch list that are not on nonaccrual or past due 90 days more are considered potential problem loans. Potential problem loans, defined as watch list loans less loans on nonaccrual or past due more than 90 days, at December 31, 2015 totaled $22.1 million compared to $27.8 million at December 31, 2014.

The following table presents a five year summary of nonperforming assets as of December 31 of each year:

Table 12. Nonperforming Assets

	December 31				
(Dollars in thousands)	2015	2014	2013	2012	2011
Nonaccrual loans					
Residential real estate 1-4 family					
First liens	$ 806	$ 1,124	$ 2,599	$ 3,584	$ 1,749
Junior liens and lines of credit	105	169	107	758	282
Total	911	1,293	2,706	4,342	2,031
Residential real estate construction	502	931	538	557	-
Commercial real estate	3,681	8,430	19,001	28,659	14,278
Commercial	276	1,637	2,398	2,836	1,447
Consumer	-	-	-	-	-
Total nonaccrual loans	5,370	12,291	24,643	36,394	17,756
Loans past due 90 days or more and still accruing					
Residential real estate 1-4 family					
First liens	214	165	302	120	2,516
Junior liens and lines of credit	-	-	41	112	301
Total	214	165	343	232	2,817
Residential real estate construction	-	-	-	-	121
Commercial real estate	152	140	207	-	1,627
Commercial	2	-	44	315	100
Consumer	-	17	10	16	107
Total loans past due 90 days or more and still accruing	368	322	604	563	4,772
Total nonperforming loans	5,738	12,613	25,247	36,957	22,528
Repossessed assets	-	-	-	-	6
Other real estate owned	6,451	3,666	4,708	5,127	3,224
Total nonperforming assets	$ 12,189	$ 16,279	$ 29,955	$ 42,084	$ 25,758
Nonperforming loans to total gross loans	0.73%	1.74%	3.49%	4.90%	2.94%
Nonperforming assets to total assets	1.18%	1.63%	3.04%	4.10%	2.60%
Allowance for loan losses to nonperforming loans	175.78%	72.23%	38.43%	28.08%	43.16%

Included in this table are $2.0 million of TDR loans that are on nonaccrual. Any TDR loan that is performing under its modified terms is not included in this table.

The following table provides information on the most significant nonaccrual loans as of December 31, 2015.

Table 13. Significant Nonaccrual Loans

December 31, 2015 (Dollars in thousands)	Balance	ALL Reserve	Nonaccrual Date	TDR Status	Collateral	Location	Last Appraisal(1)
Credit 1 - Residential real estate and commercial real estate	$ 530	-	Aug-11	N	1st lien on commercial and residential properties and 70 acres of farm land	PA	Nov-15 $ 944
Credit 2 - Residential real estate	1,877	-	Mar-12	Y	1st and 2nd liens on commercial real estate, residential real estate and business assets	PA	Oct-14 $ 3,895
Credit 3 - Commercial real estate	1,347	-	Dec-14	N	Hotel and entertainment complex	PA	Feb-15 $ 4,000
Credit 4 - Commercial real estate	655	-	Mar-14	N	1st lien on commercial real estate	PA	Nov-15 $ 1,485
	$ 4,409	$ -					

(1) Appraisal value, as reported, does not reflect the pay-off of any senior liens or the cost to liquidate the collateral, but does reflect only the Bank's share of the collateral if it is a participated loan.

Credit 1 has been paid down by $334 thousand in 2015 as the result of real estate sales. All other real estate is listed for sale except the commercial real estate that is used for business operations. The Bank is reviewing a possible troubled debt restructuring for this credit during the first quarter of 2016. Credit 2 is a TDR that is in compliance with its modified terms. Credit 3 is being operated

as part of an estate liquidation. The property has been listed for sale and a forebearance agreement has been signed with the Bank. Credit 4 was paid off in March 2016.

In addition to monitoring nonaccrual loans, the Bank also closely monitors impaired loans and troubled debt restructurings (TDR). A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Nonaccrual loans (excluding consumer purpose loans) and TDR loans are considered impaired. For impaired loans with balances less than $250 thousand and consumer purpose loans, a specific reserve analysis is not performed and these loans are added to the general allocation pool. In accordance with financial accounting standards, TDR loans are always considered impaired until they are paid-off. However, an impaired TDR loan can be a performing loan. Impaired loans totaled $16.8 million at year-end compared to $26.6 million at December 31, 2014. Included in the impaired loan total are $13.3 million of TDR loans. Note 6 of the accompanying financial statements provides additional information on the composition of the impaired loans, including the allowance for loan loss that has been established for impaired loans.

A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor’s financial difficulties, grants a concession to the debtor that it would not otherwise consider. These concessions may include lowering the interest rate, extending the maturity, reamortization of payment, or a combination of multiple concessions. The Bank reviews all loans rated 6 or worse when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance. See Note 6 in the accompanying financial statements for additional information on TDR loans.

Allowance for Loan Losses:

Management monitors loan performance on a monthly basis and performs a quarterly evaluation of the adequacy of the allowance for loan losses (ALL). The ALL is determined by segmenting the loan portfolio based on the loan’s collateral. When calculating the ALL, consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, historical charge-offs, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. The Bank begins enhanced monitoring of all loans rated 6 (OAEM) or worse, and obtains a new appraisal or asset valuation for any placed on nonaccrual and rated 7 (substandard) or worse. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on factors, including, but not limited to: the economy, deferred maintenance, industry, type of property/equipment, age of the appraisal, etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. When determining the allowance for loan losses, certain factors involved in the evaluation are inherently subjective and require material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy quarterly to the Credit Risk Oversight Committee of the Board of Directors. Management believes that the allowance for loan losses at December 31, 2015 is adequate.

The analysis for determining the ALL is consistent with guidance set forth in generally accepted accounting principles (GAAP) and the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The analysis has two components, specific and general allocations. The specific component addresses specific reserves established for impaired loans. A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Collateral values discounted for market conditions and selling costs are used to establish

specific allocations for impaired loans. However, it is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. The balance of impaired loans and the ALL for these loans declined in 2015. At December 31, 2015, the Bank had established a specific reserve of $9 thousand on one loan compared to a specific reserve of $231 thousand one-year earlier. The specific reserve has decreased since year-end 2014, primarily as the result of a second quarter 2015 charge-off of $200 thousand on a large nonaccrual loan that eliminated the $162 thousand specific reserve on this credit at December 31, 2014. This loan was then paid off. Note 6 of the accompanying financial statements provides additional information about the ALL established for impaired loans.

The general allocation component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. When calculating the general allocation, the Bank segregates its loan portfolio into the following sectors based primarily on the type of supporting collateral: residential real estate, commercial, industrial or agricultural real estate; commercial and industrial (C&I non-real estate), and consumer. The residential real estate sector is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The quantitative analysis uses the Bank's twenty quarter rolling historical loan loss experience adjusted for factors derived from current economic and market conditions that have been determined to have an effect on the probability and magnitude of a loss. Prior to 2015, the Bank was using an eight quarter rolling history for the quantitative analysis. The change to a longer historical period is based upon improving charge-offs and a more stable and slowly improving economy. As credit quality improved the Bank began to see lower charge-offs. The Bank believes that an eight quarter historical period presented the loss history during a very favorable period and it may not accurately reflect historical trends. It believes that a twenty quarter period covers a longer economic cycle and more accurately reflects its loss history and therefore is a more appropriate factor for calculating the general reserve in the current environment. The historical loss

experience factor for the general allocation was 1.07% of gross loans ($8.4 million) at December 31, 2015, compared to 1.1% of gross loans ($7.3 million) at the prior year-end. Included in the qualitative reserve was an unallocated reserve of $1.3 million and $1.0 million at December 31, 2015 and 2014, respectively. The qualitative analysis utilizes a risk matrix that incorporates qualitative and environmental factors such as: loan volume, management, loan review process, credit concentrations, competition, and legal and regulatory issues. These factors are each risk rated from minimal to high risk and in total can add up to a qualitative factor of 37.5 basis points of gross loans. At December 31, 2015, the qualitative factor was 21.5 basis points, ($1.7 million) an increase from $1.6 million at the prior year-end. These factors are determined on the basis of Management's observation, judgment and experience.

Real estate appraisals and collateral valuations are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct effect on the determination of loan reserves, charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan or relationship migrates to nonaccrual and a risk rating of 7 or worse, an evaluation for impairment status is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained. We believe this practice complies with the regulatory guidance dated December 12, 2010.

In determining the allowance for loan losses, Management, at its discretion, may determine that additional adjustments to the fair value obtained from an appraisal or collateral valuation are required. Adjustments will be made as necessary based on factors, including, but not limited to the economy, deferred maintenance, industry, type of property or equipment etc., and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. If an appraisal is not available, Management may make its best estimate of the real value of the collateral or use last known market value and apply appropriate discounts. If an adjustment is made to the collateral valuation, this will be documented with appropriate support and reported to the Loan Management Committee.

The following table shows, by loan segment, the activity in the ALL, the amount of the allowance established in each category and the loans that were evaluated for the ALL under a specific reserve (individually) and those that were evaluated under a general reserve (collectively) as of December 31, 2015.

Table 14. Loan Segment of the Allowance for Loan Losses

(Dollars in thousands)	Residential Real Estate 1-4 Family							
	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Unallocated	Total
Allowance at December 31, 2014	$ 994	$ 271	$ 214	$ 4,978	$ 1,515	$ 127	$ 1,012	$ 9,111
Charge-offs	(43)	(39)	(21)	-	(270)	(198)	-	(571)
Recoveries	7	-	18	14	148	74	-	261
Provision	31	76	(17)	657	126	99	313	1,285

Allowance at December 31, 2015	$ 989	$ 308	$ 194	$ 5,649	$ 1,519	$ 102	$ 1,325	$ 10,086
Allowance established for loans evaluated:								
Individually	$ -	$ -	$	$ -	$ 9	$ -	$ -	$ 9
Collectively	989	308	194	5,649	1,510	102	1,325	10,077
Allowance at December 31, 2015	$ 989	$ 308	$ 194	$ 5,649	$ 1,519	$ 102	$ 1,325	$ 10,086
Loans evaluated for allowance:								
Individually	$ 930	$ 51	$ 502	$ 14,309	$ 230	$ -	$ -	$ 16,022
Collectively	160,548	50,862	7,386	326,386	215,712	5,100	-	765,994
Total	$ 161,478	$ 50,913	$ 7,888	$ 340,695	$ 215,942	$ 5,100	$ -	$ 782,016

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The following tables shows the allocation of the allowance for loan losses by loan category as of December 31 for each of the past five years.

Table 15. Allocation of the Allowance for Loan Losses

(Dollars in thousands)	2015		2014		2013		2012		2011
	Balance	% of Allowance	Balance	% of Allowance	Balance	% of Allowance	Balance	% of Allowance	Balan
Residential real estate 1-4 family									
First liens	$ 989	10	$ 994	11	$ 913	9	$ 744	7	$ 955
Junior liens and lines of credit	308	3	271	3	228	2	260	3	275
Total	1,297	13	1,265	14	1,141	12	1,004	10	1,230
Residential real estate construction	194	2	214	2	276	3	882	8	1,207
Commercial real estate	5,649	56	4,978	55	5,196	54	6,078	59	5,016
Commercial	1,519	15	1,515	17	2,099	22	1,437	14	1,526
Consumer	102	1	127	1	138	1	181	2	227
Unallocated	1,325	13	1,012	11	852	9	797	8	517
	$ 10,086	100	$ 9,111	100	$ 9,702	100	$ 10,379	100	$ 9,723

The allocation of the allowance for loan losses is based on estimates and is not intended to imply limitations on the usage of the allowance. The entire allowance is available to absorb any losses without regard to the category in which the loan is classified.

The following table shows the percentage of the loans in each category to total gross loans as of December 31 for each of the past five years:

	2015	2014	2013	2012	2011
Residential real estate 1-4 family					
First liens	21%	22%	22%	21%	19%
Junior liens and lines of credit	6%	6%	6%	6%	6%
Total	27%	28%	28%	27%	25%
Residential real estate construction	1%	1%	2%	2%	3%
Commercial real estate	43%	45%	45%	48%	47%
Commercial	28%	25%	24%	22%	24%

Consumer	1%	1%	1%	1%	1%
	100%	100%	100%	100%	100%

The Bank added $1.3 million to the ALL through the provision for loan loss expense in 2015 compared to $764 thousand in the prior year. The increase in the provision expense was due primarily to growth in the commercial loan portfolio, a slight increase in the general allocation factor due to changing to a twenty quarter loss history and an increase in the unallocated component due to the level of imprecision inherent in the model. Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient proceeds from the sale of collateral to repay a loan; or (3) the borrower and/or guarantor does not own other marketable assets that, if sold, would generate sufficient sale proceeds to repay a loan.

The Bank recorded net loan charge-offs of $310 thousand in 2015 and it was the fourth straight year of a decline in net charge-offs. The following table presents details on activity in the ALL as well as key ALL ratios.

Table 16. Historical Allowance for Loan Losses

	December 31				
(Dollars in thousands)	2015	2014	2013	2012	2011
Balance at beginning of year	$ 9,111	$ 9,702	$ 10,379	$ 9,723	$ 8,801
Charge-offs:					
Residential real estate 1-4 family					
First liens	(43)	(291)	(547)	(251)	(324)
Junior liens and lines of credit	(39)	-	(45)	(71)	(202)
Total	(82)	(291)	(592)	(322)	(526)
Residential real estate construction	(21)	(41)	-	-	(2,352)
Commercial real estate	-	(408)	(2,855)	(3,298)	(3,817)
Commercial	(270)	(644)	(363)	(861)	(115)
Consumer	(198)	(189)	(162)	(236)	(237)
Total charge-offs	(571)	(1,573)	(3,972)	(4,717)	(7,047)
Recoveries:					
Residential real estate 1-4 family					
First liens	7	21	13	1	30
Junior liens and lines of credit	-	-	-	25	10
Total	7	21	13	26	40
Residential real estate construction	18	-	-	-	-
Commercial real estate	14	50	203	13	306
Commercial	148	65	100	21	11
Consumer	74	82	59	88	88
Total recoveries	261	218	375	148	445
Net charge-offs	(310)	(1,355)	(3,597)	(4,569)	(6,602)
Provision for loan losses	1,285	764	2,920	5,225	7,524
Balance at end of year	$ 10,086	$ 9,111	$ 9,702	$ 10,379	$ 9,723
Ratios:					
Net charge-offs/average gross loans	0.04%	0.19%	0.49%	0.60%	0.86%
Net charge-offs/provision for loan losses	24.12%	177.36%	123.18%	87.44%	87.75%
ALL as a percentage of loans	1.29%	1.25%	1.34%	1.38%	1.27%

The Bank holds $6.5 million of other real estate owned (OREO), comprised of seven properties compared to $3.7 million and five properties one year earlier. See Note 1 and Note 8 of the accompanying financial statements for additional information on OREO. The following table provides additional information on significant other real estate owned properties.

Table 17. Other Real Estate Owned

December 31, 2015 (Dollars in thousands)	Date Acquired	Balance	Description of Property	Location
Property 1	2012	$ 2,508	1st, 2nd, and 3rd liens residential development land - 4 tracts with 196 acres	PA
Property 2	2015	3,039	1st lien on 90 acres undeveloped commercial real estate	PA
		$ 5,547		

Property 1 was written down by $250 thousand in the third quarter of 2015 due to a bona-fide letter-of-intent that was received for the purchase of the property. The potential buyer is currently performing a due diligence review on the property. Property 2 had previously been in nonaccrual status and was moved to other real estate when the owner could not comply with the terms of a forebearance agreement. This property is part of a participated credit and the workout is being handled by the lead bank.

At December 31, 2015, the Bank had $218 thousand of residential properties in the process of foreclosure compared to $763 thousand at the end of 2014.

Goodwill:

The Bank has $9.0 million of goodwill recorded on its balance sheet as the result of corporate acquisitions. Goodwill is not amortized, nor deductible for tax purposes. However, goodwill is tested for impairment at least annually in accordance with ASC Topic 350. Goodwill was tested for impairment as of August 31, 2015. The impairment test was conducted following the step-one test under ASC Topic 350. The Corporation chose not to use the qualitative assessment method for the August 31, 2015 test primarily due to the fact that the Corporation's stock price was trading below its book value. The Corporation uses several different weighted methods to determine the fair value of the reporting unit under the step-one test, including a dividend analysis, comparable sale transactions, and change of control premium estimates. If the step-one test fails, a more comprehensive step-two test is performed before a final

determination of impairment is made. If goodwill is determined to be impaired, an impairment write-down is charged to results of operations in the period in which the impairment is determined. As a result of the step-one test, the estimated fair value of the Corporation exceeded its carrying value by approximately 38% (compared to 37% in 2014) and Management determined goodwill was not impaired. The increase in the valuation excess compared to 2014 is primarily the result of an increase in the Corporation's stock price during 2015 and improved financial performance. At December 31, 2015, Management subsequently considered certain qualitative factors affecting the Corporation and determined that it was not likely that the results of the prior test had changed and it determined that goodwill was not impaired at year-end.

Deposits:

The Bank depends on deposits generated by its community banking offices as its primary source of funds. The Bank offers numerous deposit products including demand deposits (noninterest and interest-bearing accounts), savings, money management accounts, and time deposits (certificates of deposits/CDs). Table 18 shows a comparison of the major deposit categories over a five-year period, including balances and the percentage change in balances year-over-year. Table 3, presented previously, shows the average balance of the major deposit categories and the average cost of these deposits over a three year period.

Table 18. Deposits

	December 31								
(Dollars in thousands)	2015		2014		2013		2012		2011
	Balance	% Change	Balance	% Change	Balance	% Change	Balance	% Change	Balance
Noninterest-bearing checking	$ 152,095	11.1	$ 136,910	12.6	$ 121,565	(1.7)	$ 123,623	18.6	$ 104,245
Interest-bearing checking	232,181	19.1	194,992	8.1	180,450	33.2	135,454	15.3	117,479
Money management	379,331	(2.2)	388,043	4.8	370,401	(2.5)	380,079	16.5	326,219
Savings	69,174	10.4	62,637	5.5	59,394	3.9	57,165	10.5	51,728
Retail time deposits	82,468	(11.3)	92,973	(14.1)	108,283	(15.3)	127,861	(13.3)	147,479
Brokered time deposits	3,263	(42.0)	5,626	(0.1)	5,631	(88.8)	50,258	23.1	40,836
Total deposits	$ 918,512	4.2	$ 881,181	4.2	$ 845,724	(3.3)	$ 874,440	11.0	$ 787,986

Noninterest-bearing checking: Noninterest-bearing demand deposit accounts represent a very valuable funding source to the Bank. The category increased by 11.1 % in 2015 with the increase occurring primarily in commercial and retail checking accounts.

Interest-bearing checking: This category saw an increase in both the ending and average balance for the year compared to prior year-end. The growth in this category occurred primarily in the new fully-insured interest-bearing checking account that was introduced in 2013. This account attracted commercial and large dollar accounts that lost the full FDIC insurance coverage at the end of 2013. In addition, the Bank actively moved the majority of its Repo accounts into this fully-insured product.

Money management: This category showed a decrease from the prior year, primarily in commercial accounts, which were partially offset by increases in retail accounts.

Savings: Savings accounts increased 10.4% during the year and represents the seventh consecutive year of growth. Retail savings accounts, IRA savings and health savings accounts accounted for the largest growth categories within this product.

Time deposits: Retail time deposits have declined for the sixth consecutive year. Retail time deposits greater than $100 thousand totaled $21.0 million compared to $24.0 million at year-end 2014. Consumers do not seem to be inclined to invest in longer maturity deposits as they want more liquid accounts and are afraid of missing out on the opportunity to take advantage of rising rates, whenever that may occur. As a result of this sentiment, the Bank has seen some maturing CDs migrate to the Money Management product and new CDs being written for short-terms. In 2016, 64% of the Bank's retail CDs will mature.

At year-end 2015 the Bank had $3.3 million placed into the CDARS program that allows the Bank to offer full FDIC coverage to large depositors, but with the convenience to the customer of only having to deal with one bank. The Bank solicits these deposits from within its market and it believes they present no greater risk than any other local deposit. However, regulatory guidance requires that these deposits be classified as brokered deposits. The Bank had no wholesale brokered CDs at year-end.

The Bank continues to review different methods of funding growth that include traditional deposits and other wholesale sources. Competition from other local financial institutions, internet banks and brokerages will continue to be a challenge for the Bank in its efforts to attract new and retain existing deposit accounts. This competition is not expected to lessen in the future.

The following table shows the maturity of outstanding time deposits of $100,000 or more at December 31, 2015:

Table 19. Time Deposits of $100,000 or More

(Dollars in thousands)	Retail Time Deposits	Brokered Time Deposits	Total Time Deposits
Maturity distribution:			
Within three months	$ 6,075	$ -	$ 6,075
Over three through six months	3,168	250	3,418
Over six through twelve months	4,687	1,958	6,645
Over twelve months	7,053	517	7,570
Total	$ 20,983	$ 2,725	$ 23,708

Borrowings:

Short-term Borrowings: Short-term borrowings from the FHLB are in the form of a revolving term commitment. The short-term FHLB borrowings are used as overnight borrowings to fund the short-term liquidity needs of the Bank. These borrowings reprice on a daily basis and the interest rate fluctuates with short-term market interest rates. At December 31, 2015, the available amount on this line of credit was $35.0 million.

The Bank had previously used securities sold under repurchase agreements (Repo), which are accounted for as collateralized financings, as an additional funding source. During 2014, the Bank began the process of closing this product and transitioning these accounts into a fully-insured sweep deposit product. At the end of 2014, the Bank had one remaining Repo account and it was closed

on January 2, 2015. By moving accounts out of the Repo product, the Bank was able to free up its investment collateral and improve its liquidity position by having less pledged collateral. The following table presents information about the Bank's Repo product and short-term borrowings.

Table 20. Short-Term Borrowings and Securities Sold Under Agreements to Repurchase

(Dollars in thousands)	2015		2014		2013	
	Short-Term Borrowings	Repurchase Agreements	Short-Term Borrowings	Repurchase Agreements	Short-Term Borrowings	Repurchase Agreements
Ending balance	$ -	$ -	$ -	$ 9,079	$ -	$ 23,834
Average balance	923	25	-	8,539	-	32,407
Maximum month-end balance	3,500	-	-	17,755	-	52,880
Weighted-average interest rate	0.38%	0.15%	-	0.15%	-	0.15%

Long-term Debt: During 2014, the Bank prepaid its remaining advances with FHLB and the Bank had no long-term debt outstanding during 2015.

Shareholders' Equity:

Shareholders' equity increased $7.9 million to $111.4 million at December 31, 2015. The Corporation added $7.1 million to retained earnings after declaring $3.1 million in dividends. The Dividend Reinvestment Plan (DRIP) added $1.2 million in new capital during 2015. The Corporation declared regular cash dividends per share of $0.74 in 2015. The increase in net income reduced the dividend payout ratio to 30.8% in 2015 compared to 33.9% in 2014. The Corporation made no repurchases of its stock in 2015.

The Board of Directors has in the past authorized the repurchase of the Corporation's $1.00 par value common stock. The repurchased shares can be held as treasury shares available for issuance in connection with future stock dividends and stock splits, employee benefit plans, executive compensation plans and other appropriate corporate purposes. The term of the repurchase plans is normally one year. For additional information on Shareholders' Equity refer to Note 18 of the accompanying consolidated financial statements. There was no stock repurchase plan in place during 2015.

The Corporation's dividend reinvestment plan (DRIP) allows for shareholders to purchase additional shares of the Corporation's common stock by reinvesting cash dividends paid on their shares or through optional cash payments. The Corporation has authorized 1,000,000 shares of common stock to be issued under the amended plan. During 2015, 52,755 shares of common stock were purchased through the dividend reinvestment plan at a value of $1.2 million and 639,585 shares remain to be issued.

A strong capital position is important to the Corporation as it provides a solid foundation for the future growth of the Corporation, as well as instills confidence in the Bank by depositors, regulators and investors, and is considered essential by Management. The Corporation is continually exploring other sources of capital as part of its capital management plan for the Corporation and the Bank.

Common measures of adequate capitalization for banking institutions are capital ratios. These ratios indicate the proportion of permanently committed funds to the total asset base. Guidelines issued by federal and state regulatory authorities require both banks and bank holding companies to meet minimum leverage capital ratios and risk-based

capital ratios.

The leverage ratio compares Tier 1 capital to average assets while the risk-based ratio compares Tier 1 and total capital to risk-weighted assets and off-balance-sheet activity in order to make capital levels more sensitive to the risk profiles of individual banks. Tier 1 capital is comprised of common stock, additional paid-in capital, retained earnings and components of other comprehensive income, reduced by goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses.

The Corporation, as a bank holding company, is required to comply with the capital adequacy standards established by Federal Reserve Board. The Bank is required to comply with capital adequacy standards established by the FDIC. In addition, the Pennsylvania Department of Banking also requires state chartered banks to maintain a 6% leverage capital level and 10% risk based capital, defined substantially the same as the federal regulations.

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3)Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.125%, increasing each year until fully implemented in 2019 at 2.5% above the

minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of December 31, 2015, the Bank was "well capitalized' under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such a requirement been in effect. The minimum capital ratios (shown as "adequately capitalized") and the "well capitalized" capital ratios are reported on Note 2 of the accompanying financial statements. The following table provides information on the Corporation's capital ratio.

Table 21. Capital Ratios

	December 31		
	2015	2014	2013
Common Equity Tier 1 risk-based capital ratio	15.08%	-	-
Total risk-based capital ratio	16.34%	15.49%	14.24%
Tier 1 risk-based capital ratio	15.08%	14.19%	12.97%
Tier 1 leverage ratio	10.59%	9.69%	9.14%

For additional information on capital adequacy refer to Note 2 of the accompanying consolidated financial statements

Local Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 15,000 in Fulton County to over 243,000 in Cumberland County. Unemployment in the Bank's market area has improved during 2015 and ranges from a low of 3.5% in Cumberland County to high of 5.5% in Fulton County. The market area has a diverse economic base and local industries include, warehousing, truck & rail shipping centers, light and heavy manufacturers, health-care, higher education institutions, farming and agriculture, and a varied service sector. The Corporation's primary market area is located in south central Pennsylvania and provides easy access to the major metropolitan markets on the east coast via trucking and rail transportation. Because of this, warehousing and distribution companies continue to find the area attractive. The local economy is not overly dependent on any one industry or business and Management believes that the Bank's primary market area continues to be well suited for growth. The following provides selected economic data for the Bank's primary market:

Economic Data

	December 31	
	12/31/2015	12/31/2014
Unemployment Rate (seasonally adjusted)		
Market area range (1)	3.5 - 5.5%	3.6 - 5.8%
Pennsylvania	5.0%	5.1%

United States	5.0%	5.8%
Housing Price Index - year over year change		
PA, nonmetropolitan statistical area	2.0%	0.5%
United States	5.6%	5.7%
Franklin County Building Permits - year over year change		
Residential, estimated	-15.6%	32.7%
Multifamily, estimated	-65.0%	157.8%

(1) Franklin, Cumberland, Fulton and Huntingdon Counties

Unlike many companies, the assets and liabilities of the Corporation are financial in nature. As such, interest rates and changes in interest rates may have a more significant effect on the Corporation's financial results than on other types of industries. Because of this, the Corporation watches the actions of the Federal Reserve Open Market Committee (FOMC) as it makes decisions about interest rate changes and monetary policy. In December 2015, the FOMC made a "lift-off" decision—the first increase in the federal funds rate target range, and consequently the prime rate, in nearly 10 years. Looking ahead to 2016, the timing and magnitude or rate increases will be data dependent. In determining the timing and size of future adjustments to the target range for the federal funds rate, the FOMC will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. We expect that the normalization of monetary policy will be quite gradual. With the expectations of moderate growth and uncertainties overseas, there may be a long wait between a few rate hikes.

Liquidity

The Corporation must meet the financial needs of the customers that it serves, while providing a satisfactory return on the shareholders' investment. In order to accomplish this, the Corporation must maintain sufficient liquidity in order to respond quickly to the changing level of funds required for both loan and deposit activity. The goal of liquidity management is to meet the ongoing cash flow requirements of depositors who want to withdraw funds and of borrowers who request loan disbursements. The Bank regularly reviews it liquidity position by measuring its projected net cash flows (in and out) at a 30 and 90-day interval. The Bank stresses this measurement by assuming a level of deposit out-flows that have not historically been realized. In addition to this forecast, other funding sources are reviewed as a method to provide emergency funding if necessary. The objective of this measurement is to identify the amount of cash that could be raised quickly without the need to liquidate assets. The Bank also stresses its liquidity position utilizing different longer-term scenarios. The varying degrees of stress create pressure on deposit flows in its local market, reduce access to wholesale funding and limit access of funds available through brokered deposit channels. In addition to stressing cash flow, specific liquidity risk indicators are monitored to help identify risk areas. This analysis will help identify and quantify the potential cash surplus/deficit over a variety of time horizons to ensure the Bank has adequate funding resources. Assumptions used for liquidity stress testing are subjective. Should an evolving liquidity situation or business cycle present new data, potential assumption changes will be considered. The Bank believes it can meet all anticipated liquidity demands.

Historically, the Corporation has satisfied its liquidity needs from earnings, repayment of loans, amortizing and maturing investment securities, loan sales, deposit growth and its ability to access existing lines of credit. All investment securities are classified as available for sale; therefore, securities that are not pledged as collateral for borrowings are an additional source of readily available liquidity, either by selling the security or, more preferably, to provide collateral for additional borrowing. At December 31, 2015, the Bank had approximately $74 million (fair value) of its investment portfolio pledged as collateral for deposits. Another source of available liquidity for the Bank is a line of credit with the FHLB. At December 31, 2015, the Bank had approximately $35 million available on this line of credit and $6 million in an unsecured line of credit at a correspondent bank. The Corporation's maximum borrowing capacity with the FHLB at December 31, 2015 was approximately $252 million.

The FHLB system has always been a major source of funding for community banks. There are no indicators that lead the Bank to believe the FHLB will discontinue its lending function or restrict the Bank's ability to borrow. If either of these events were to occur, it would have a negative effect on the Bank and it is unlikely that the Bank could replace the level of FHLB funding in a short time.

The Bank has established credit at the Federal Reserve Discount Window and as of year-end had the ability to borrow approximately $24 million.

Off Balance Sheet Commitments

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist mainly of unfunded loans and letters of credit made under the same standards as on-balance sheet loans and lines of credit. Because these unfunded instruments have fixed maturity dates and many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to the Corporation. Unused commitments and standby letters of credit totaled $265.4 million and $25.9 million, respectively, at December 31, 2015, compared to $248.3 million and $22.7 million,

respectively, at December 31, 2014. See Note 19 of the accompanying consolidated financial statements for more information on commitments and contingencies.

Management believes that any amounts actually drawn upon can be funded in the normal course of operations. The Corporation has no investment in or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity.

The following table represents the Corporation's aggregate on and off balance sheet contractual obligations to make future payments as of December 31, 2015.

Table 22. Contractual Obligations

(Dollars in thousands)

	1 year and under	Years 2-3	Years 4-5	Over 5 years	Total
Time deposits	$ 54,466	$ 24,296	$ 6,969	$ -	$ 85,731
Operating leases	734	1,277	983	4,514	7,508
Deferred compensation	146	292	292	148	878
Estimated future pension payments	1,616	2,197	2,671	5,398	11,882
Total	$ 56,962	$ 28,062	$ 10,915	$ 10,060	$ 105,999

The Corporation is not aware of any known trends, demands, commitments, events or uncertainties which would result in any material increase or decrease in liquidity. The Corporation has also entered into an interest rate swap agreement as part of its interest rate risk management strategy. See Note 14 of the accompanying financial statements for more information on financial derivatives.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market Risk

In the course of its normal business operations, the Corporation is exposed to certain market risks. The Corporation has no foreign currency exchange rate risk, no commodity price risk or material equity price risk. However, it is exposed to interest rate risk. All interest rate risk arises in connection with financial instruments entered into for purposes other than trading. Financial instruments, which are sensitive to changes in market interest rates, include fixed and variable-rate loans, fixed-income securities, derivatives, interest-bearing deposits and other borrowings.

Changes in interest rates can have an impact on the Corporation's net interest income and the economic value of equity. The objective of interest rate risk management is to identify and manage the sensitivity of net interest income and economic value of equity to changing interest rates in order to achieve consistent earnings that are not contingent upon favorable trends in interest rates.

The Corporation uses several tools to measure and evaluate interest rate risk. One tool is interest rate sensitivity or gap analysis. Gap analysis classifies assets and liabilities by repricing and maturity characteristics and provides Management with an indication of how different interest rate scenarios will impact net interest income. Table 23 presents a gap analysis of the Corporation's balance sheet at December 31, 2015. A positive gap in the under one-year time interval suggests that, all else being equal, the Corporation's near-term earnings would rise in a higher interest rate environment and decline in a lower rate environment. A negative gap suggests the opposite result. At December 31, 2015, the Corporation's cumulative gap position at one year was negative. However, the incremental benefit of future rate decreases has been reduced as the rates paid on the Bank's liabilities have been reduced greatly, leaving little room for future reductions. In addition, many of the liabilities are reported in Table 23 at the earliest period at which the rate could change. Since these rates change at the discretion of the Bank, certain liabilities may or may not be repriced with the same magnitude or at the same time as market rates. These circumstances are not captured by a gap analysis. Consequently, gap analysis is not a good indicator of future earnings.

Another tool for analyzing interest rate risk is financial simulation modeling which captures the effect of not only changing interest rates but also other sources of cash flow variability including loan and securities prepayments and customer preferences. Financial simulation modeling forecasts both net interest income and the economic value of equity under a variety of different interest rate environments that cannot be captured with a gap analysis. The Corporation regularly measures the effects of multiple yield curve rate changes. The magnitude of each change scenario may vary depending on the current interest rate environment In addition, the balance sheet is held static in each scenario so that the effect of an interest rate change can be isolated and not distorted by changes in the balance sheet.

Table 24 presents the results of three different rate change scenarios and measures the change in net interest income against a base (unchanged) scenario. As shown, the Bank's net interest income compared to the base scenario decreases in the down 100 basis point scenario, but increases in each of the up scenarios. For each scenario, interest rate changes are ramped up or down over a period of 1 year, except for the plus 400 basis point scenario which is ramped over 2 years. The Bank believes a ramp scenario is more realistic than an interest rate shock scenario; however, the Bank also runs scenarios using shocks and yield curve twists. Economic value of equity (EVE) is defined as the estimated discounted present value of assets minus the discounted present value of liabilities and is a

surrogate for long-term earnings. EVE measures the degree to which the economic value of a bank changes under different rate scenarios. EVE focuses on a longer-term time horizon and captures all balance sheet cash flows and is more effective in considering embedded options. The discount rates used in the EVE calculation are based on market rates for like assets and liabilities and the balance sheet position is held constant in order to isolate the risk of interest rate changes. For EVE simulation, all rates change by the defined amount immediately and simultaneously in a shock fashion.

Computations of prospective effects of hypothetical interest rate changes are based on many assumptions, including relative levels of market interest rates, loan prepayments and deposit repricing. Certain shortcomings are inherent in the computation of discounted present value and, if key relationships do not unfold as assumed, actual values may differ from those presented. Further, the computations do not contemplate any actions Management could undertake in response to changes in market interest rates.

The following table shows interest rate sensitivity for the Corporation as of December 31, 2015.

Table 23. Interest Rate Sensitivity Analysis

(Dollars in thousands)	1-90 Days	91-181 Days	182-365 Days	1-5 Years	Beyond 5 Years	Total
Interest-earning assets:						
Interest -bearing deposits in other banks	$ 6,844	$ 4,934	$ 1,750	$ 4,474	$ 500	$ 18,502
Investment securities and restricted stock	10,578	5,868	14,271	84,060	45,478	160,255
Loans	281,606	34,605	98,922	262,042	104,841	782,016
Total interest-earning assets	299,028	45,407	114,943	350,576	150,819	960,773
Interest-bearing liabilities:						
Interest-bearing checking	232,181	-	-	-	-	232,181
Money market deposit accounts	379,331	-	-	-	-	379,331
Savings	69,174	-	-	-	-	69,174
Time	17,926	13,852	22,688	31,265	-	85,731
Total interest-bearing liabilities	$ 698,612	$ 13,852	$ 22,688	$ 31,265	$ -	$ 766,417