ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 09, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2017

Commission file number: 001-34292
ORRSTOWN FINANCIAL SERVICES, INC.
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania	23-2530374
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania	17257
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (717) 532-6114
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, No Par Value	The NASDAQ Capital Market

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x
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 x
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨		Accelerated filer	x
Non-accelerated filer ¨	(Do not check if a smaller reporting company)	Smaller reporting company	¨
		Emerging growth company	¨
			¨

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

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

The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the Registrant’s most recently completed second fiscal quarter, was approximately $180.9 million. For purposes of this calculation, the term “affiliate” refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant’s common stock.

Number of shares outstanding of the registrant’s common stock as of February 28, 2018: 8,412,247.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2018 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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Glossary of Defined Terms

The following terms may be used throughout this Report, including the consolidated financial statements and related notes.

Term	Definition
ALL	Allowance for loan losses
AFS	Available for sale
AOCI	Accumulated other comprehensive income (loss)
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Bank	Orrstown Bank, the commercial banking subsidiary of Orrstown Financial Services, Inc.
CET1	Common Equity Tier 1
CMO	Collateralized mortgage obligation
Company	Orrstown Financial Services, Inc. and subsidiaries (interchangeable with "Orrstown" below)
EPS	Earnings per common share
ERM	Enterprise risk management
Exchange Act	Securities Exchange Act of 1934, as amended
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FRB	Board of Governors of the Federal Reserve System
GAAP	Accounting principles generally accepted in the United States of America
GSE	United States government-sponsored enterprise
IRC	Internal Revenue Code of 1986, as amended
LHFS	Loans held for sale
MBS	Mortgage-backed securities
MPF Program	Mortgage Partnership Finance Program
MSR	Mortgage servicing right
NIM	Net interest margin
OCI	Other comprehensive income (loss)
OFA	Orrstown Financial Advisors, a division of the Bank that provides investment and brokerage services
OREO	Other real estate owned (foreclosed real estate)
Orrstown	Orrstown Financial Services, Inc. and subsidiaries
OTTI	Other-than-temporary impairment
Parent Company	Orrstown Financial Services, Inc., the parent company of Orrstown Bank and Wheatland Advisors, Inc.
2011 Plan	2011 Orrstown Financial Services, Inc. Incentive Stock Plan
Repurchase Agreements	Securities sold under agreements to repurchase
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933, as amended
TDR	Troubled debt restructuring
U.S.	United States of America
Wheatland	Wheatland Advisors, Inc., the Registered Investment Advisor subsidiary of Orrstown Financial Services, Inc.

Unless the context otherwise requires, the terms “Orrstown,” “we,” “us,” “our,” and “Company” refer to Orrstown Financial Services, Inc. and its subsidiaries.

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PART I

Forward-Looking Statements:

From time to time, Orrstown has made and may continue to make written or oral forward-looking statements regarding our outlook for earnings, revenues, expenses, capital and liquidity levels and ratios, asset levels, asset quality, financial position and other matters regarding or affecting Orrstown and its future business and operations or the impact of legal, regulatory or supervisory matters on our business operations or performance. This Annual Report on Form 10-K also includes forward-looking statements. With respect to all such forward-looking statements, you should review our Risk Factors discussion in Item 1A, our Critical Accounting Policies and Cautionary Statement About Forward-Looking Statements sections included in Item 7, and Note 19, Contingencies, in the Notes To Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K. We encourage readers of this report to understand forward-looking statements to be strategic objectives rather than absolute targets of future performance. Forward-looking statements speak only as of the date they are made. We do not intend to update publicly any forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

ITEM 1 – BUSINESS

Orrstown Financial Services, Inc., a Pennsylvania corporation, is the holding company for its wholly-owned subsidiaries Orrstown Bank and Wheatland Advisors, Inc. The Company's principal executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, 17257, with additional executive and administrative offices at 4750 Lindle Road, Harrisburg, Pennsylvania, 17111. The Parent Company was organized on November 17, 1987, for the purpose of acquiring the Bank and such other banks and bank-related activities as are permitted by law and desirable. The Company provides banking and bank-related services through branches located in south central Pennsylvania, principally in Berks, Cumberland, Dauphin, Franklin, Lancaster, and Perry Counties and in Washington County, Maryland. Wheatland was acquired in December 2016 and provides services as a registered investment advisor through its office in Lancaster County, Pennsylvania.

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

Business

The Bank was originally organized in 1919 as a state-chartered bank. On March 8, 1988, in a bank holding company reorganization transaction, the Parent Company acquired 100% ownership of the Bank.

The Parent Company's primary activity consists of owning and supervising its subsidiaries, the Bank and Wheatland. Day-to-day management is conducted by its officers, who are also Bank officers. The Parent Company has historically derived most of its income through dividends from the Bank. At December 31, 2017, the Company had total assets of $1,558,849,000, total shareholders' equity of $144,765,000 and total deposits of $1,219,515,000.

The Parent Company has no employees. Its nine officers are employees of the Bank. On December 31, 2017, the Bank and Wheatland combined had 321 full-time and 17 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank holds commercial, residential, consumer and agribusiness loans primarily in its market areas of Cumberland, Dauphin, Franklin, Lancaster and Perry Counties in Pennsylvania; Washington County, Maryland; and in contiguous counties. The concentrations of credit by type of loan are included in Note 4, Loans and Allowance for Loan Losses, to the

Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." The Bank maintains a diversified loan portfolio and evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management's credit evaluation of the customer pursuant to collateral standards established in the Bank's credit policies and procedures.

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Wheatland was acquired to supplement the Bank's trust and wealth management group and to provide opportunities for future growth in these areas.

Lending

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

Commercial Lending

A majority of the Company’s loan assets are loans for business purposes. Approximately 63% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank’s various markets.

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

Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans primarily through its branch network and customer call center. A large majority of the consumer loans are secured by either a first or second lien position on the borrower’s primary residential real estate. The Bank requires a LTV of no greater than 90% of the value of the real estate being taken as collateral. We also, at times, purchase consumer loans to help diversify credit risk in our loan portfolio.

Residential Lending

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

Loan Review

The Bank has a loan review policy and program which is designed to identify and monitor risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank’s loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an independent review of the Bank’s loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession, or death of the borrower occurs, which heightens awareness as to a possible credit event.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed quarterly and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

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

Investment Services

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name "Orrstown Financial Advisors." OFA offers retail brokerage services through a third-party broker/dealer arrangement with Cetera Advisor Networks LLC. Wheatland also offers investment advisor services as a registered investment advisor. At December 31, 2017, assets under management by OFA and Wheatland totaled $1,370,950,000.

Regulation and Supervision

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

The Bank is a Pennsylvania-chartered commercial bank and a member of the FRB. The operations of the Bank are subject to federal and state statutes applicable to banks chartered under Pennsylvania law, to FRB member banks and to banks whose deposits are insured by the FDIC. The Bank’s operations are also subject to regulations of the Pennsylvania Department of Banking and Securities, the FRB and the FDIC.

Wheatland is subject to periodic examination by the SEC.

Several of the more significant regulatory provisions applicable to bank holding companies and banks to which the Company and the Bank are subject are discussed below, along with certain regulatory matters concerning the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, such information is qualified in its entirety by reference to the particular statutes or regulations. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

Financial and Bank Holding Company Activities

As an FHC, we are permitted to engage, directly or through subsidiaries, in a wide variety of activities that are financial in nature or are incidental or complementary to a financial activity, in addition to all of the activities otherwise allowed to us.

As an FHC, the Company is generally subject to the same regulation as other bank holding companies, including the reporting, examination, supervision and consolidated capital requirements of the FRB. To preserve our FHC status, we must remain well-capitalized and well-managed and ensure that the Bank remains well-capitalized and well-managed for regulatory purposes and earns “satisfactory” or better ratings on its periodic Community Reinvestment Act (“CRA”) examinations. An FHC ceasing to meet these standards is subject to a variety of restrictions, depending on the circumstances.

If the Parent Company or the Bank are either not well-capitalized or not well-managed, the Parent Company or the Bank must promptly notify the FRB. Until compliance is restored, the FRB has broad discretion to impose appropriate limitations on an FHC’s activities. If compliance is not restored within 180 days, the FRB may ultimately require the FHC to divest its depository institutions or in the alternative, to discontinue or divest any activities that are permitted only to non-FHC bank holding companies.

If the FRB determines that an FHC or its subsidiaries do not satisfy the CRA requirements, the potential restrictions are different. In that case, until all the subsidiary institutions are restored to at least “satisfactory” CRA rating status, the FHC may not engage, directly or through a subsidiary, in any of the additional activities permissible under the BHC Act nor make additional acquisitions of companies engaged in the additional activities. However, completed acquisitions and additional activities and affiliations previously begun are left undisturbed, as the BHC Act does not require divestiture for this type of situation.

Federal Financial Regulatory Reform

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), enacted in 2010, substantially increased regulatory oversight and enforcement and imposed additional costs and risks on the operations of financial holding companies and banks.

The Dodd-Frank Act materially changed the regulation of financial institutions and the financial services industry and created a framework for regulatory reform. The Dodd-Frank Act and the regulations thereunder, some of which are still being drafted and implemented,include provisions affecting large and small financial institutions alike, including several provisions that affect the regulation of community banks and bank holding companies.

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The Dodd-Frank Act, among other things, imposed new capital requirements on bank holding companies; changed the base for FDIC insurance assessments to a bank's average consolidated total assets minus average tangible equity, rather than upon its deposit base; permanently raised the current standard deposit insurance limit to $250,000; and expanded the FDIC's authority to raise insurance premiums. The legislation also called for the FDIC to raise its ratio of reserves to deposits from 1.15% to 1.35% for deposit insurance purposes by September 30, 2020 and to "offset the effect" of increased assessments on insured depository institutions with assets of less than $10 billion.

The Dodd-Frank Act also included provisions that affect corporate governance and executive compensation at all publicly-traded companies and allows financial institutions to pay interest on business checking accounts. The legislation also restricts proprietary trading by banking organizations, places restrictions on the owning or sponsoring of hedge and private equity funds, and regulates the derivatives activities of banks and their affiliates. The Dodd-Frank Act established the Financial Stability Oversight Council to identify threats to the financial stability of the U.S., promote market discipline, and respond to emerging threats to the stability of the U.S. financial system.

The Dodd-Frank Act also established the Consumer Financial Protection Bureau (the "CFPB") as an independent entity funded by the FRB. The CFPB has broad rulemaking, supervisory and enforcement authority over consumer financial products and services, including deposit products, residential mortgages, home-equity loans and credit cards. The CFPB's rules contain provisions on mortgage-related matters such as steering incentives, and determinations as to a borrower's ability to repay, loan servicing, and prepayment penalties. The CFPB has primary examination and enforcement authority over banks with over $10 billion in assets as to consumer financial products.

One of the announced goals of the CFPB is to bring greater consumer protection to the mortgage servicing market. The CFPB has defined a "qualified mortgage" for purposes of the Dodd-Frank Act, and set standards for mortgage lenders to determine whether a consumer has the ability to repay the mortgage. It has also issued regulations affording safe harbor legal protections for lenders making qualified loans that are not "higher priced." The CFPB's regulations contain new mortgage servicing rules applicable to the Bank, which took effect in 2014. Changes affect notices to be given to consumers as to delinquency, foreclosure alternatives, modification applications, interest rate adjustments and options for avoiding "force-placed" insurance. Servicers are prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than 120 days delinquent before initiating a foreclosure action.

The servicer must provide direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred.

The Bank presently services 5,000 or fewer mortgage loans which it owns or originated, so it is considered a "Small Servicer" and is exempt from certain parts of the mortgage servicing rules. The mortgage servicing requirements applicable to the Bank's servicing operations under the new mortgage servicing rules are: adjustable rate mortgage interest rate adjustment notices; prompt payment crediting and payoff statements; limits on force-placed insurance; responses to written information requests and complaints of errors; and loss mitigation with regard to the first notice or filing for a foreclosure and no foreclosure proceedings if a borrower is performing pursuant to the terms of a loss mitigation agreement.

Federal Deposit Insurance

The Bank's deposits are insured to applicable limits by the FDIC. The maximum deposit insurance amount is $250,000 under the Dodd-Frank Act.

The FDIC is required by the Dodd-Frank Act to return its insurance reserve ratio to 1.35% no later than September 30, 2020. Once the fund reaches 1.15%, banks larger than $10 billion in assets will be required to assume the burden of bringing the fund to 1.35%.

On June 30, 2016, the Federal Deposit Insurance Fund reached the 1.15% ratio. As required by the Dodd-Frank Act, the FDIC changed its calculation of FDIC insurance premiums. Institutions are now assigned a base rate using their examination ratings, which is then adjusted based on their leverage ratio, net income before taxes to total assets ratio, nonperforming loans and leases to gross assets ratio, other real estate owned to gross assets ratio, loan mix index, and one-year asset growth rate. The result is then further adjusted to reflect its level of unsecured debt issued, the level of

unsecured depository institution debt it owns, and the level of brokered deposits (excluding reciprocal deposits) it has issued above regulatory minimums.
If the FDIC is appointed conservator or receiver of a bank upon the bank’s insolvency or the occurrence of other events, the FDIC may sell some, part or all of a bank’s assets and liabilities to another bank or repudiate or disaffirm most types of contracts to which the bank was a party if the FDIC believes such contracts are burdensome. In resolving the estate of a failed bank, the FDIC as receiver will first satisfy its own administrative expenses, and the claims of holders of U.S. deposit liabilities also have priority over those of other general unsecured creditors.

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Liability for Banking Subsidiaries

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

Pennsylvania Banking Law

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

Dividend Restrictions

The Parent Company’s funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Parent Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future may be influenced by bank regulatory policies and capital guidelines.

Regulatory Capital Requirements

Compliance by the Company and the Bank with respect to capital requirements is incorporated by reference from Note 13, Shareholders' Equity and Regulatory Capital, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," and from the Capital Adequacy and Regulatory Matters section of Item 7, “Management’s Discussion and Analysis of Consolidated Financial Condition and Results of Operations.”

Basel III Capital Rules

Effective January 1, 2015, the Company and the Bank became subject to the Basel III Capital Rules, which substantially revised risk-based capital requirements. The Basel III Capital Rules revised the definitions and components of regulatory capital, addressed other issues affecting the numerator in banking institutions’ regulatory capital ratios, asset risk weights and other matters affecting the denominator in banking institutions’ regulatory capital ratios and replaced the existing general risk-weighting approach.

The Basel III Capital Rules introduced a new capital measure called Common Equity Tier 1 and a related regulatory capital ratio of CET1 to risk-weighted assets; increased the minimum requirements for Tier 1 Capital ratio as well as the minimum levels to be considered well capitalized under prompt corrective action; and introduced the “capital conservation buffer,” designed to absorb losses during periods of economic stress. Institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer are subject to constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall. When fully phased-in on January 1, 2019, the capital standards applicable to the Parent Company and the Bank will include an additional capital conservation buffer of 2.5% of CET1, effectively resulting in minimum ratios inclusive of the capital conservation buffer of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) Total capital to risk-weighted assets of at least 10.5%.

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The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized from net operating loss carrybacks and significant investments in unconsolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories, in the aggregate, exceed 15% of CET1.

Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive income items are not excluded from regulatory capital, including unrealized gains or losses on certain securities available for sale; however, certain banking organizations were able to make a one-time permanent election with the first filing of reports under the Basel III Capital Rules to continue to exclude these items. The Parent Company and Bank made this one-time permanent election, with the result that most AOCI items will be excluded from regulatory capital.

Implementation of the deductions and other adjustments to CET1 were phased in and will be fully implemented beginning January 1, 2018.

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories to a larger and more risk-sensitive number of categories than previously used, depending on the nature of the assets. These categories generally range from 0%, for U.S. government and agency securities, to 600%, for certain equity exposures, and result in higher risk weights for a variety of asset categories.

Other Federal Laws and Regulations

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

- Privacy provisions of the Gramm-Leach-Bliley Act (the "GLB Act") and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to “opt out” of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;
- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the GLB Act; and
- the USA PATRIOT Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

Future Legislation and Regulation

Changes in federal laws and regulations, as well as laws and regulations in states where the Parent Company and the Bank do business, can affect the operating environment of the Company and the Bank in substantial ways. We cannot predict whether those changes in laws and regulations will occur, and, if they occur, the ultimate effect they would have upon the financial condition or results of operations of the Company.

NASDAQ Capital Market

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

Competition

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

We are subject to robust competition in our market areas. Like other depository institutions, we compete with less heavily regulated entities such as credit unions, brokerage firms, money market funds, consumer finance and credit card companies, and with other commercial banks, many of which are larger than the Bank. The principal methods of competing effectively in the

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financial services industry include improving customer service through the quality and range of services provided, improving efficiencies and pricing services competitively. The Bank is competitive with the financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

We continue to implement strategic initiatives focused on expanding our core businesses and to explore, on an ongoing basis, acquisition, divestiture, and joint venture opportunities to the extent permitted by our regulators. We analyze each of our products and businesses in the context of shareholder return, customer demands, competitive advantages, industry dynamics, and growth potential. We believe our market area will support growth in assets and deposits in the future, which we expect to contribute to our ability to maintain or grow profitability.

ITEM 1A – RISK FACTORS

An investment in our common stock is subject to risks inherent in our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our business, financial condition and results of operations could be materially and adversely affected. If this were to happen, the market price of our common stock could decline significantly, and you could lose all or part of your investment.

Risks Related to Credit

If our allowance for loan losses is not sufficient to cover actual losses, our earnings would decrease.

There is no precise method of predicting loan losses. The required level of reserves, and the related provision for loan losses, can fluctuate from year to year, based on charge-offs and/or recoveries, loan volume, credit administration practices, and local and national economic conditions, among other factors. In 2017, we recorded a provision for loan losses of $1,000,000 compared with a provision expense totaling $250,000 in 2016. The Company recorded net charge-offs of $979,000 in 2017 compared with net charge-offs of $1,043,000 in 2016. Risk elements, including nonperforming loans, troubled debt restructurings still accruing, loans greater than 90 days past due still accruing, and other real estate owned totaled $11,987,000 at December 31, 2017 compared with $8,319,000 at December 31, 2016.

The ALL, which is a reserve established through a provision for loan losses charged to expense, represents management's best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management's evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the ALL inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our ALL.

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

The ALL was 1.27% of total loans and 116% of nonaccrual and restructured loans still accruing at December 31, 2017, compared with 1.45% of total loans and 160% of nonaccrual and restructured loans still accruing at December 31, 2016. In addition, at December 31, 2017, the top 25 lending relationships individually had commitments of $86,506,000, and an aggregate total outstanding loan balance of $182,950,000, or 18% of the loan portfolio. The deterioration of one or more of these loan relationships could result in a significant increase in the nonperforming loans and the provisions for loan losses, which would negatively impact our results of operations.

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Commercial real estate lending may expose us to a greater risk of loss and impact our earnings and profitability.
Our business strategy involves making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than other loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than other loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to conditions in the real estate market or the local economy. In challenging economic conditions, these loans represent higher risk and could result in an increase in our total net charge-offs, requiring us to increase our ALL, which could have a material adverse effect on our financial condition or results of operations. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.
Commercial and industrial loans comprise 11% of our loan portfolio. The credit risk related to these types of loans is greater than the risk related to residential loans.
Our commercial and industrial loan portfolio grew by $27,198,000, or 31%, during the year ended December 31, 2017 to $115,663,000. Commercial and industrial loans generally carry larger loan balances and involve a greater degree of risk of nonpayment or late payment than home equity loans or residential mortgage loans.
Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower’s accounts receivable, inventory and machinery and equipment. In a significant number of these loans, the collateral also includes the business real estate or the business owner’s personal real estate or assets. Commercial and industrial loans are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. We attempt to mitigate this risk through our underwriting standards, including evaluating the creditworthiness of the borrower and, to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.
Our commercial and industrial lending operations are located primarily in south central Pennsylvania and in Washington County, Maryland. Our borrowers’ ability to repay these loans depends largely on economic conditions in these and surrounding areas. A deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans.
Risks Related to Interest Rates and Investments
Changes in interest rates could adversely impact the Company’s financial condition and results of operations.
Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate environment. Operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on interest-earning assets, such as loans and securities, and the interest rates we pay on interest-bearing liabilities, such as deposits and borrowings. These rates are highly sensitive to many factors beyond our control, including competition; general economic conditions; and monetary and fiscal policies of various governmental and regulatory authorities, including the FRB. If the rate of interest we pay on our interest-bearing liabilities increases more than the rate of interest we receive on our interest-earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on interest-earning assets fall more quickly than those on our interest-bearing liabilities.
Changes in interest rates also can affect our ability to originate loans; the ability of borrowers to repay adjustable or variable rate loans; our ability to obtain and retain deposits in competition with other available investment alternatives; and the value of interest-earning assets, which would negatively impact stockholders’ equity, and the ability to realize gains from the sale of such assets. Based on our interest rate sensitivity analyses, an increase in the

general level of interest rates will negatively affect the market value of the investment portfolio because of the relatively higher duration of certain securities included in the investment portfolio.

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Risks Related to Competition and to Our Business Strategy

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

Our operations are sensitive to general business and economic conditions in the U.S. If the growth of the U.S. economy slows, or if the economy worsens or enters into a recession, our growth and profitability could be constrained. In addition, economic conditions in foreign countries can affect the stability of global financial markets, which could impact the U.S. economy and financial markets. Weak economic conditions are characterized by deflation, fluctuations in debt and equity capital markets, including a lack of liquidity and/or depressed prices in the secondary market for mortgage loans, increased delinquencies on mortgage, consumer and commercial loans, residential and commercial real estate price declines and lower home sales and commercial activity. All of these factors are detrimental to our business. Our business is significantly affected by monetary and related policies of the U.S. federal government, its agencies and government-sponsored entities. Changes in any of these policies could have a material adverse effect on our business, financial position, results of operations and cash flows.

In particular, we may face the following risks in connection with volatility in the economic environment:

- Loan delinquencies could increase;
- Problem assets and foreclosures could increase;
- Demand for our products and services could decline; and
- Collateral for loans made by us, especially real estate, could decline in value, reducing customers' borrowing power, and reducing the value of assets and collateral associated with our loans.

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

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

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

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

As we expand our on-line lending capabilities, we will face competition, particularly in residential mortgage lending, from non-bank lenders (financial institutions that only make loans and do not offer deposit accounts such as a savings account or checking account) and financial technology companies (that use new technology and innovation with available resources in order to compete in the marketplace of traditional financial institutions and intermediaries in the delivery of financial services). This competition could similarly reduce our net income and liquidity.

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

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The Company’s business strategy includes the continuation of moderate growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.
Loans grew $126,621,000, or 14% from $883,391,000 at December 31, 2016, to $1,010,012,000 at December 31, 2017, due to organic growth through increases in consumer, commercial and commercial real estate loans. Over the long term, we expect to continue to experience growth in loans and total assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to successfully execute our business strategies, which includes continuing to grow our loan portfolio. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards. In addition, our asset quality metrics have improved sufficiently that we may consider the acquisition of other financial institutions and branches within or outside of our market area to the extent permitted by our regulators. The success of any such acquisition will depend on a number of factors, including our ability to integrate the acquired institutions or branches into the current operations of the Company; our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations; our ability to control the incremental increase in noninterest expense arising from any acquisition; and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. We believe we have the resources and internal systems in place to successfully achieve and manage our future growth. If we do not manage our growth effectively, we may not be able to achieve our business plan and our business and prospects could be harmed.
The Company may be adversely affected by technological advances.
Technological advances impact our business. The banking industry undergoes technological change with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success may depend, in part, on our ability to address the needs of our current and prospective customers by using technology to provide products and services that will satisfy demands for convenience as well as to create additional efficiencies in operations.
The Company may not be able to attract and retain skilled people.
The Company’s success depends, in large part, on our ability to attract and retain skilled people. We have, at times, experienced turnover among our senior officers. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to attract and hire sufficiently skilled people to fill open and newly created positions or to retain current or future employees. An inability to attract and retain individuals with the necessary skills to fill open positions, or the unexpected loss of services of one or more of our key personnel, could have a material adverse impact on our business due to the loss of their skills, knowledge of our markets, years of industry experience or the difficulty of promptly finding qualified replacement personnel.
An interruption or breach in security with respect to our information systems, or our outsourced service providers, could adversely impact the Company’s reputation and have an adverse impact on our financial condition or results of operations.
Information systems are critical to our business. We use various technological systems to manage our customer relationships, general ledger, securities investments, deposits and loans. We rely on software, communication, and information exchange on a variety of computing platforms and networks and over the internet. We have established policies and procedures to prevent or limit the effect of system failures, business interruptions and security breaches, but we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. In addition, any compromise of our systems could deter customers from using our products and services. Although we rely on security systems to provide security and authentication necessary to effect the secure transmission of data, these precautions may not protect our systems from security breaches.
We rely on the services of a variety of vendors to meet our data processing and communication needs. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and we could be exposed to claims from customers. Any of these results could have a material adverse effect on our financial condition, results of operations or liquidity.

We could be adversely affected by failure in our internal controls.

A failure in our internal controls could have a significant negative impact not only on our earnings, but also on the perception that customers, regulators and investors may have of us. We continue to devote a significant amount of effort and resources to continually strengthening our controls and ensuring compliance with complex accounting standards and banking regulations. However, these efforts may not be effective in preventing a breach in our controls.

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Negative public opinion could damage our reputation and adversely affect our earnings.
Reputational risk, or the risk to the Company's earnings and capital from negative public opinion, is inherent in our business. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, including banking operations and trust and investment operations, our management of actual or potential conflicts of interest and ethical issues, and our protection of confidential client information. Negative public opinion can adversely affect the Company's ability to keep and attract customers and can expose the Company to litigation and regulatory action. Although we take steps to minimize reputation risk in the way we conduct our business activities and deal with our customers, communities and vendors, these steps may not be effective.
Risks Related to Regulatory Compliance and Legal Matters
Governmental regulation and regulatory actions against us may impair our operations or restrict our growth.
The Company is subject to regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. The Company cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.
The Dodd-Frank Act may affect the Company’s financial condition, results of operations, liquidity and stock price.
The Dodd-Frank Act includes provisions affecting large and small financial institutions, including several provisions that affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax rules regarding interstate branching; allow financial institutions to pay interest on business checking accounts; change the scope of federal deposit insurance coverage; and impose new capital requirements on bank holding companies. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and will be subject to implementation regulations developed over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is not certain.
The Dodd-Frank Act created the CFPB which has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets are examined by their applicable bank regulators.
The Company may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act. Failure to comply with the new requirements may negatively impact our results of operations and financial condition. While the Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, these changes could be materially adverse to our investors.
Increases in FDIC insurance premiums may have a material adverse effect on our results of operations.
Market developments significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. As the fund continues to recover, the Company may be required to pay significantly higher premiums or additional special assessments or taxes that could adversely affect earnings. We are generally unable to control the amount of premiums that are required to be paid for FDIC insurance. If there are additional bank or financial institution failures, the Company may be required to pay even higher FDIC premiums than the levels currently imposed. Any future increases or required prepayments in FDIC insurance premiums may materially

adversely affect the results of operations.
Legislative, regulatory and legal developments involving income and other taxes could materially adversely affect the Company’s results of operations and cash flows.

The Company is subject to U.S. federal and U.S. state income, payroll, property, sales and use, and other types of taxes including the Pennsylvania Bank Shares Tax. Significant judgment is required in determining the Company's provisions for

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income taxes. Changes in tax rates, enactments of new tax laws, revisions of tax regulations, and claims or litigation with taxing authorities could result in substantially higher taxes, and therefore, could have a significant adverse effect on the Company's results of operations, financial condition and liquidity. Increases in the assessment rate for the Pennsylvania Bank Shares Tax, which is calculated on the outstanding equity of the Bank, may also materially adversely affect results of operations.

Any U.S. federal tax reform that lowers corporate tax rates could have a significant non-cash adverse effect on results of operations as the Company's net deferred tax asset would be impacted, resulting in an increase in tax expense. In December 2017, U.S. federal tax reform was enacted that, among other things, lowered our statutory tax rate to 21% effective January 1, 2018. As described more fully in Note 7, Income Taxes, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," the Company was required to remeasure its net deferred tax asset at the date the tax reform was enacted and incurred a $2,635,000 expense, which is included in total tax expense for 2017. We are unable to predict if, or when, any additional changes or proposals could be enacted.

The Company is required to use judgment in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to the reports of financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the ALL, accounting for income taxes and the ability to recognize deferred tax assets, and the fair value of certain financial instruments, particularly securities. While we have identified those accounting policies that we consider critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could have a material adverse effect on our financial condition and results of operations.

Changes in accounting standards could impact the Company's financial condition and results of operations.

The Financial Accounting Standards Board (the "FASB"), the SEC and other regulatory bodies periodically change financial accounting and reporting standards that govern the preparation of the Company’s consolidated financial statements. These changes, including the use of an expected loss impairment methodology in the determination of the ALL which will be effective for the Company beginning January 1, 2020, can be hard to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply new or revised guidance retrospectively, which may result in the revision of prior financial statements by material amounts. The implementation of new or revised guidance could result in material adverse effects to our reported regulatory capital.

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

The Basel III Capital Rules which became effective for the Company and Bank on January 1, 2015, established a new comprehensive capital framework for U.S. banking organizations, including community banks. The Basel III Capital Rules substantially revised the risk-based capital requirements applicable to bank holding companies and depository institutions. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions’ regulatory capital ratios, as well as address risk weights and other issues affecting the denominator in banking institutions’ regulatory capital ratios.

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

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

As more fully described in Note 19, Contingencies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statement and Supplementary Data," of this Annual Report on Form 10-K, the allegations of Southeastern Pennsylvania Transportation Authority's ("SEPTA") proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the SEC. On September 27, 2016, the Company entered into a settlement agreement with the SEC resolving the investigation of accounting and related matters at the Company for the periods ended June 30, 2010 to December 31, 2011. As part of the settlement agreement, the Company agreed to pay a civil money penalty of $1 million. On January 31, 2017, the Court entered a Case Management Order establishing the schedule for the litigation. The Case Management Order, among other things, sets the deadlines for the completion of discovery, the filing of motions and various pre-trial conferences. The trial is scheduled to begin on January 7, 2019.

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The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims. It is not possible at this time to estimate losses, if any, with the litigation. However, there can be no assurances that the Company will not incur any losses associated with this litigation or that any losses that are incurred will not be material.

Indemnification costs associated with litigation and legal proceedings could adversely impact the Company and its financial condition and results of operations.

We are generally required, to the extent permitted by Pennsylvania law, to indemnify our current and former directors and officers who are named as defendants in lawsuits. We also have certain contractual indemnification obligations to third parties regarding litigation. Generally, insurance coverage is not available for such indemnification costs we could incur to third parties. Current or future litigation could result in indemnification expenses that could have a materially adverse impact on our financial condition and results of operations.

Risks Related to Liquidity

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

The Parent Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments and stock repurchases, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. In addition, our right to participate in a distribution of assets upon the Bank’s liquidation or reorganization is subject to the prior claims of the Bank’s creditors.

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

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

Risks Related to Owning our Stock

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

Federal banking regulators require us and our banking subsidiary to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2017, all four capital ratios for us and our banking subsidiary were above regulatory minimum levels to be deemed “well capitalized” under current bank regulatory guidelines. To be “well capitalized,” banking companies generally must maintain a tier 1 leverage ratio of at least 5.0%, CET1 capital ratio of 6.5%, Tier 1 risk-based capital ratio of at least 8.0%, and a total risk-based capital ratio of at least 10.0%. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

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

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The market price of our common stock has been subject to volatility.
The market price of the Company’s common stock has been subject to fluctuations in response to numerous factors, many of which are beyond our control. These factors include actual or anticipated variations in our operational results and cash flows, changes in financial estimates by securities analysts, trading volume, large purchases or sales of our common stock, market conditions within the banking industry, the general state of the securities markets and the market for stocks of financial institutions, as well as general economic conditions.
The Parent Company's primary source of income is dividends received from its bank subsidiary.
The Parent Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company is responsible for paying any dividends declared to its shareholders. The Company also has repurchased shares of its common stock. The Company’s primary source of income is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid from the Bank to the Company without prior approval of regulatory agencies. Restrictions on the Bank’s ability to dividend funds to the Company are included in Note 14, Restrictions on Dividends, Loans and Advances, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."
ITEM 1B – UNRESOLVED STAFF COMMENTS
None.

ITEM 2 – PROPERTIES
Our principal executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, with additional executive and administrative offices at 4750 Lindle Road, Harrisburg, Pennsylvania. These facilities are owned by the Bank, which also maintains its principal and additional executive and administrative offices at those locations.

We own or lease other premises for use in conducting our business activities, including bank branches, an operations center, and offices in Berks, Cumberland, Dauphin, Franklin, Lancaster, and Perry Counties, Pennsylvania and Washington County, Maryland. We believe that the properties currently owned and leased are adequate for present levels of operation. We are constantly evaluating the best and most efficient mix of branch locations to service our customers due to evolving trends in our industry and increased engagement through digital channels.

ITEM 3 – LEGAL PROCEEDINGS
Information regarding legal proceedings is included in Note 19, Contingencies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statement and Supplementary Data."
ITEM 4 – MINE SAFETY DISCLOSURES
Not applicable.

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PART II

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

Market Information

Our common stock is traded on the NASDAQ Capital Market under the symbol "ORRF." At the close of business on February 28, 2018, there were approximately 2,700 shareholders of record.

The following table sets forth for each quarter of 2017 and 2016 the high and low sales prices per share of our common stock and the cash dividends declared. Trading prices are based on published financial sources.

	2017			2016		
	Market Price		Quarterly	Market Price		Quarterly
	High	Low	Dividend	High	Low	Dividend
First quarter	$23.40	$20.00	$ 0.10	$18.11	$16.60	$ 0.08
Second quarter	23.00	19.05	0.10	19.95	17.05	0.09
Third quarter	26.55	22.15	0.10	23.73	17.59	0.09
Fourth quarter	26.95	24.15	0.12	23.75	18.05	0.09
			$ 0.42			$ 0.35

Our management is currently committed to continuing to pay regular cash dividends; however, there can be no assurance as to future dividends because they are dependent on our future earnings, capital requirements and financial condition. Restrictions on the payment of dividends are discussed in Note 14, Restrictions on Dividends, Loans and Advances, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." On January 24, 2018, the Board declared a cash dividend of $0.12 per common share, which was paid on February 9, 2018.

Issuer Purchases of Equity Securities

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time.

No shares were repurchased from October 1, 2017 to December 31, 2017. At December 31, 2017, 82,725 shares had been repurchased under the program at a total cost of $1,438,000, or $17.38 per share. The maximum number of shares that may yet be purchased under the plan is 333,275 shares at December 31, 2017.

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PERFORMANCE GRAPH

The performance graph below compares the cumulative total shareholder return on our common stock with other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. The graph assumes an investment of $100 on December 31, 2012 and reinvestment of dividends on the date of payment without commissions. Shareholder returns on our common stock are based upon trades on the NASDAQ Stock Market. The performance graph represents past performance and should not be considered to be an indication of future performance.

	Period Ending					
Index	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Orrstown Financial Services, Inc.	100.00	169.61	176.35	187.42	239.80	275.16
SNL Bank $1B-$5B Index	100.00	145.41	152.04	170.20	244.85	261.04
S&P 500 Index	100.00	132.39	150.51	152.59	170.84	208.14
NASDAQ Composite Index	100.00	140.12	160.78	171.97	187.22	242.71

Source : S&P Global Market Intelligence © 2017

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

Recent Sales of Unregistered Securities

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

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ITEM 6 – SELECTED FINANCIAL DATA

	At or For The Year Ended December 31,				
(Dollars in thousands except per share information)	2017	2016	2015	2014	2013
Summary of Operations					
Interest and dividend income	$51,015	$41,962	$38,635	$38,183	$37,098
Interest expense	7,644	5,417	4,301	4,159	5,011
Net interest income	43,371	36,545	34,334	34,024	32,087
Provision for loan losses	1,000	250	(603)	(3,900)	(3,150)
Net interest income after provision for loan losses	42,371	36,295	34,937	37,924	35,237
Investment securities gains	1,190	1,420	1,924	1,935	332
Noninterest income	19,197	18,319	17,254	16,919	17,476
Noninterest expenses	50,330	48,140	44,607	43,768	43,247
Income before income tax expense (benefit)	12,428	7,894	9,508	13,010	9,798
Income tax expense (benefit)	4,338	1,266	1,634	(16,132)	(206)
Net income	$8,090	$6,628	$7,874	$29,142	$10,004
Per Share Information					
Basic earning per share	$1.00	$0.82	$0.97	$3.59	$1.24
Diluted earnings per share	0.98	0.81	0.97	3.59	1.24
Dividends per share	0.42	0.35	0.22	0.00	0.00
Book value at December 31	17.34	16.28	16.08	15.40	11.28
Weighted average shares outstanding – basic	8,070,472	8,059,412	8,106,438	8,110,344	8,093,306
Weighted average shares outstanding – diluted	8,226,261	8,145,456	8,141,600	8,116,054	8,093,306
Stock Price Statistics					
Close	$25.25	$22.40	$17.84	$17.00	$16.35
High	26.95	23.75	18.45	17.50	18.00
Low	19.05	16.60	15.10	15.33	9.49
Price earnings ratio at close	25.3	27.3	18.4	4.7	13.2
Diluted price earnings ratio at close	25.8	27.7	18.4	4.7	13.2
Price to book at close	1.5	1.4	1.1	1.1	1.4
Year-End Information					
Total assets	$1,558,849	$1,414,504	$1,292,816	$1,190,443	$1,177,812
Loans	1,010,012	883,391	781,713	704,946	671,037
Total investment securities	425,305	408,124	402,844	384,549	416,864
Deposits – noninterest-bearing	162,343	150,747	131,390	116,302	116,371
Deposits – interest-bearing	1,057,172	1,001,705	900,777	833,402	884,019
Total deposits	1,219,515	1,152,452	1,032,167	949,704	1,000,390
Repurchase agreements	43,576	35,864	29,156	21,742	9,032
Borrowed money	133,815	76,163	84,495	79,812	66,077
Total shareholders' equity	144,765	134,859	133,061	127,265	91,439
Assets under management – market value	1,370,950	1,174,143	966,362	1,017,013	1,085,216
Financial Ratios					
Average equity / average assets	9.49 %	10.41 %	10.66 %	8.63 %	7.45 %
Return on average equity	5.73 %	4.80 %	5.99 %	28.78 %	11.30 %
Return on average assets	0.54 %	0.50 %	0.64 %	2.48 %	0.84 %

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

The following discussion and analysis is intended to assist readers in understanding the consolidated financial condition and results of operations of Orrstown and should be read in conjunction with our Consolidated Financial Statements and notes thereto included in this Annual Report on Form 10-K. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications.

Overview

The results of our operations are highly dependent on economic conditions and market interest rates. The Company's profitability for the years ended December 31, 2017, 2016 and 2015 was influenced by its continued organic growth and ongoing expansion into targeted markets, while it maintained improvement in asset quality from prior years. These and other matters are discussed more fully below.

Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with GAAP and follow general practices within the financial services industry. Application of these principles involves complex judgments and estimates by management that have a material impact on the carrying value of certain assets and liabilities. The judgments and estimates that we used are based on historical experiences and other factors, which we believe are reasonable under the circumstances. Because of the nature of the judgments and estimates that we have made, actual results could differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities and the results of our operations.

The most significant accounting policies followed by the Company are presented in Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." These policies, along with the disclosures presented in the other consolidated financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the ALL and accounting for income taxes as critical accounting policies.

The ALL represents management’s estimate of probable incurred credit losses in the loan portfolio at the balance sheet date. Determining the amount of the ALL is considered a complex accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset on the consolidated balance sheets.

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of income in the period in which they are enacted. The Company records deferred tax assets to the extent the Company believes these assets will more likely than not be realized, utilizing a valuation allowance if all or a portion of the deferred tax assets is not so considered to be realized. In making this determination, the Company considers all available evidence, including future reversals of existing deferred tax liabilities, projected future taxable income, feasible and prudent tax planning strategies and recent financial operating results. In the event the Company was to determine that it would be able to realize deferred tax assets in the future in excess of their net recorded amount, an adjustment to the valuation allowance would be made that would impact income tax expense. Management may need to modify its judgment in this regard, from one period to another, should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company’s ability to benefit from the asset in the future.

On December 22, 2017, federal tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act"), was enacted. Among other things, the Tax Act reduced the Company's statutory federal tax rate from 34% to 21% effective January 1, 2018. As a result, we were required to remeasure, through income tax expense, certain deferred tax assets and liabilities using the enacted rate at which we expect them to be recovered or settled.

The remeasurement of our net deferred tax asset resulted in additional federal deferred tax expense of $2,635,000, which is included in total tax expense for 2017. The Company's deferred tax assets related to low-income housing credit and alternative minimum tax credit carryforwards were not impacted by the change in statutory tax rate, as they are treated as payments on future federal income taxes due and are not subject to remeasurement. However, the Tax Act did change alternative minimum tax credit carryforwards to be refundable credits. To reflect this change, the Company reclassed its alternative minimum tax credit carryforwards, totaling $5,343,000 at December 31, 2017, from deferred tax assets to other assets in the consolidated balance sheets.

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

Economic Climate, Inflation and Interest Rates

The pace of U.S. economic growth has recently increased above the modest two percent average of the recent expansion. The passage of tax cuts, a federal budget with significantly increased government spending, and the possibility of an infrastructure bill all contribute to a more positive consensus outlook for 2018. This expansion is now within 14 months of becoming the longest expansion since World War II. There are signs that this expansion is reaching maturity: credit spreads are near their historical lows, the unemployment rate has approached four percent, and the yield curve is flatter.

The majority of the assets and liabilities of a financial institution are monetary in nature, and therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an impact on the growth of total assets and on noninterest expenses, which tend to rise during periods of general inflation. Inflationary pressures over the last several years have been modest, however, with the current unemployment rate and fiscal stimulus on the way, concerns that inflation may increase faster than the last several years are starting to make their way into economic forecasts and may pressure interest rates higher.

As the Company's balance sheet consists primarily of financial instruments, interest income and interest expense are greatly influenced by the level of interest rates and the slope of the yield curve. During the first two of the three years presented in this financial statement review, interest rates were near all-time lows. The FRB began raising short term interest rates in December 2015 and raised the Fed Funds rate 25 basis points four more times between December of 2016 and December of 2017. The yield curve shifted upward with the increase in the Fed Funds rate with short term rates increasing further than long term rates resulting in a flatter yield curve. The Company has been able to grow its net interest income by $9,037,000 from 2015 to 2017, through the growth of loans and higher yielding securities in combination with slower increases in its funding costs. Competition for quality lending opportunities remains intense, which, together with a flattening yield curve, will continue to challenge our ability to grow our net interest margin and to leverage our overhead expenses.

Results of Operations

Summary

The Company recorded net income of $8,090,000, $6,628,000 and $7,874,000 for 2017, 2016 and 2015. Diluted earnings per share totaled $0.98, $0.81 and $0.97 for 2017, 2016 and 2015.

Net interest income totaled $43,371,000, $36,545,000 and $34,334,000 for 2017, 2016 and 2015, principally reflecting our organic growth in loans from an expanded sales force and efforts to expand our geographic footprint while taking advantage of market opportunities. A higher interest rate environment each year contributed to increased yields on loans and investments, and, to a lesser extent, costs of interest-bearing liabilities.

Favorable historical charge-off data and management's emphasis on loan quality have impacted our results, as the allowance for loan losses has remained stable as loans have increased. The provision for loan losses totaled $1,000,000 and $250,000 in 2017 and 2016. In 2015, a negative provision or recovery of amounts previously provided for or charged-off totaling $(603,000) was recognized.

Noninterest expenses totaled $50,330,000, $48,140,000 and $44,607,000 for 2017, 2016 and 2015. The changes in certain components of noninterest expenses between the years are reflective of the Company's focus on investing in additional talent and locations to better serve the needs of our customers and efforts to develop new relationships by taking advantage of market opportunities created by consolidation of other banks. Salaries and employee benefits increased $2,314,000 from 2015 to 2016 and $3,775,000 from 2016 to 2017. Occupancy and furniture and fixture costs increased $544,000 from 2015 to 2016 and $414,000 from 2016 to 2017.

Income tax expense totaled $4,338,000, $1,266,000 and $1,634,000 for 2017, 2016 and 2015, or an effective tax rate of 34.9%, 16.0% and 17.2% respectively. In 2017, we remeasured our net deferred tax asset due to the enactment of the Tax Act in December 2017. The Tax Act lowered our statutory tax rate from 34% to 21% effective January 1, 2018. Remeasurement of our net deferred tax asset at the lower rate resulted in an expense of $2,635,000, which is included in total tax expense for 2017.

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Net Interest Income

Net interest income is the primary component of the Company's revenue. Interest-earning assets include loans, securities and federal funds sold. Interest-bearing liabilities include deposits and borrowed funds.

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

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. Our loan portfolio is affected by changes in the prime interest rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, remained at 3.25% during most of 2015. In December 2015, the prime rate increased 25 basis points to 3.50% and remained at that level through most of 2016. In December 2016, the prime rate increased 25 basis points to end the year at 3.75%. During 2017, the prime rate increased 75 basis points (25 basis points in each of March, June and December) to end the year at 4.50%.

Core deposits are deposits that are stable, lower cost and generally reprice more slowly than other deposits when interest rates change. Core deposits are typically funds of local customers who also have a borrowing or other relationship with the Bank. We are primarily funded by core deposits, with noninterest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on our net interest income and net interest margin in a rising interest rate environment.

Net interest income totaled $43,371,000, $36,545,000 and $34,334,000 in 2017, 2016 and 2015. The following table presents net interest income, net interest spread and net interest margin on a taxable-equivalent basis for 2017, 2016 and 2015. Taxable-equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 34% federal corporate tax rate for 2017 and 2016 and 35% for 2015, reflecting our statutory tax rates for those years.

Effective January 1, 2018, the Tax Act changed our statutory tax rate to 21%. As a result of this lower tax rate, taxable-equivalent adjustments in future years will be less than if the 2017 tax rate had remained in effect.

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(Dollars in thousands)	2017 Average Balance	2017 Taxable-Equivalent Interest	2017 Taxable-Equivalent Rate	2016 Average Balance	2016 Taxable-Equivalent Interest	2016 Taxable-Equivalent Rate	2015 Average Balance	2015 Taxable-Equivalent Interest	2015 Taxable-Equivalent Rate
Assets									
Federal funds sold and interest-bearing bank balances	$15,487	$218	1.41 %	$31,452	$208	0.66 %	$18,901	$81	0.43 %
Taxable securities	326,900	7,478	2.29	303,124	6,012	1.98	348,613	6,697	1.92
Tax-exempt securities	93,683	4,748	5.07	57,231	2,767	4.83	33,055	1,629	4.93
Total securities	420,583	12,226	2.91	360,355	8,779	2.44	381,668	8,326	2.18
Taxable loans	893,555	38,568	4.32	774,984	32,036	4.13	687,079	28,787	4.19 %
Tax-exempt loans	50,797	2,450	4.82	58,281	2,848	4.89	59,600	3,094	5.19
Total loans	944,352	41,018	4.34	833,265	34,884	4.19	746,679	31,881	4.27
Total interest-earning assets	1,380,422	53,462	3.87	1,225,072	43,871	3.58	1,147,248	40,288	3.51
Cash and due from banks	20,391			20,803			19,155		
Bank premises and equipment	35,055			31,413			24,386		
Other assets	65,293			61,391			56,894		
Allowance for loan losses	(12,738)			(13,529)			(14,134)		
Total	$1,488,423			$1,325,150			$1,233,549		
Liabilities and Shareholders’ Equity									
Interest-bearing demand deposits	$648,174	2,148	0.33	$565,524	1,195	0.21	$500,474	908	0.18
Savings deposits	94,815	150	0.16	90,272	144	0.16	85,068	136	0.16
Time deposits	292,616	3,836	1.31	289,574	3,472	1.20	263,414	2,562	0.97
Short-term borrowings	97,814	784	0.80	56,387	187	0.33	85,262	295	0.35
Long-term debt	36,336	726	2.00	24,335	419	1.72	22,522	400	1.78
Total interest-bearing liabilities	1,169,755	7,644	0.65	1,026,092	5,417	0.53	956,740	4,301	0.45
Noninterest-bearing demand deposits	161,917			147,473			134,040		
Other	15,450			13,612			11,316		
Total Liabilities	1,347,122			1,187,177			1,102,096		
Shareholders’ Equity	141,301			137,973			131,453		
Total	$1,488,423			$1,325,150			$1,233,549		
Taxable-equivalent net interest income / net interest spread		45,818	3.22 %		38,454	3.05 %		35,987	3.06 %
Taxable-equivalent net interest margin			3.32 %			3.14 %			3.14 %

Taxable-equivalent adjustment	(2,447)	(1,909)	(1,653)
Net interest income	$43,371	$36,545	$34,334

Note: Yields and interest income on tax-exempt assets have been computed on a taxable-equivalent basis assuming a 34% tax rate in 2017 and 2016, and 35% in 2015. For yield calculation purposes, nonaccruing loans are included in the average loan balance.

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The following table presents changes in net interest income on a taxable-equivalent basis for 2017, 2016 and 2015 by rate and volume components.

(Dollars in thousands)	2017 Versus 2016 Increase (Decrease) Due to Change in Average Volume	Average Rate	Total	2016 Versus 2015 Increase (Decrease) Due to Change in Average Volume	Average Rate	Total
Interest Income						
Federal funds sold and interest-bearing bank balances	$ (106)	$ 116	$ 10	$ 54	$ 73	$ 127
Taxable securities	472	994	1,466	(874)	189	(685)
Tax-exempt securities	1,762	219	1,981	1,191	(53)	1,138
Taxable loans	4,901	1,631	6,532	3,683	(434)	3,249
Tax-exempt loans	(366)	(32)	(398)	(68)	(178)	(246)
Total interest income	6,663	2,928	9,591	3,986	(403)	3,583
Interest Expense						
Interest-bearing demand deposits	175	778	953	118	169	287
Savings deposits	7	(1)	6	8	0	8
Time deposits	36	328	364	254	656	910
Short-term borrowings	137	460	597	(100)	(8)	(108)
Long-term debt	207	100	307	32	(13)	19
Total interest expense	562	1,665	2,227	312	804	1,116
Net Interest Income	$ 6,101	$ 1,263	$ 7,364	$ 3,674	$ (1,207)	$ 2,467

Note: The change attributed to volume is calculated by taking the average change in average balance times the prior year's average rate and the remainder is attributable to rate.

2017 versus 2016

In 2017, net interest income, on a taxable-equivalent basis, increased $7,364,000, or 19.2%, compared with 2016. The Company’s net interest spread increased 17 basis point to 3.22% for 2017 compared with 2016.

Interest income on a taxable-equivalent basis on loans increased $6,134,000, or 17.6%, from 2016 to 2017. The increase resulted from an increase in both average loan volume and yield, with average loans increasing $111,087,000, or 13.3%, and yield increasing 15 basis points from 4.19% in 2016 to 4.34% in 2017. The Company's geographic expansion and sales efforts with additional loan officers continued to drive loan growth in 2017 across most loan classes. Increases in prime lending rates during the year contributed to the increased yield, but a flattening yield curve partially offset the benefit of the rate increases.

Interest income earned on a taxable-equivalent basis on securities increased $3,447,000, or 39.3%, from 2016 to 2017, with both average volume and yield increasing. Average securities increased $60,228,000, or 16.7%, and yield increased from 2.44% in 2016 to 2.91% in 2017. Contributing to the increase in interest income on securities was the higher rate environment in 2017, a higher composition of tax free securities with accompanying higher taxable-equivalent yields and strategic moves within the portfolio as the interest rate environment changed.

Interest expense on deposits and borrowings increased $2,227,000 from 2016 to 2017, as the average balance of interest-bearing liabilities increased $143,663,000, or 14.00%. Generally, the cost of interest-bearing liabilities has increased at a slower pace than yields earned on interest-earning assets in 2017, as the market for interest-bearing liabilities was initially slower to respond to interest rate changes.

Our ability to attract new deposits in all categories, but in particular interest-bearing demand deposits, resulted in an increase in average interest-bearing deposits totaling $82,650,000, or 14.6%, in 2017. Interest expense for these deposits increased $953,000, with the cost of funds increasing from 0.21% in 2016 to 0.33% in 2017.

We also increased our short-term and long-term borrowings in 2017 to partially fund loan and investment portfolio growth. Borrowings generally have higher interest rates associated with them. Interest expense on borrowings increased $904,000 in 2017, with average balances increasing $41,427,000 for short-term borrowings and $12,001,000 for long-term borrowings. The average rate paid on short-term borrowings increased from 0.33% in 2016 to 0.80% in 2017 and the average rate paid on long-term borrowings increased from 1.72% in 2016 to 2.00% in 2017.

2016 versus 2015

Net interest income, on a taxable-equivalent basis, increased $2,467,000, or 6.9%, from 2015 to 2016. The Company's net interest spread decreased 1 basis point to 3.05% for 2016 compared with 2015. Despite higher average balances in loans during 2016 compared with 2015 and a 25 basis point increase in the prime lending rate between the years, a flattening yield curve as the market reacted to slowing economic growth negatively impacted the yields on loans and caused funding costs to increase. Payments on and maturities of existing loans were reinvested at lower rates due to competitive market conditions. An increase in securities yields helped increase the average yield earned on interest-earning assets for 2016 compared with 2015 and helped maintain the net interest margin at the same 3.14% as in 2015. The average interest rate increased as the Company was able to invest a large portion of the additional funds at rates above the FRB's target for the Fed Funds rate.

Interest income on a taxable-equivalent basis on loans increased $3,003,000, or 9.4%, from 2015 to 2016. The increase in interest income on loans was primarily a result of an increase in average loan volume, offset partially by a decrease in yield, which decreased eight basis points from 4.27% for 2015 to 4.19% for 2016. Average loans increased $86,586,000 from 2015 to 2016 and reflected successful sales efforts across most loan classes. Favorable market conditions and the addition of several seasoned loan officers contributed to loan growth. However, new loans added were generally at lower rates than the existing portfolio.

Interest income earned on a taxable-equivalent basis on securities increased $453,000, or 5.4%, from 2015 to 2016. The average balance of securities decreased $21,313 from 2015 to 2016, with funds obtained from maturing and prepaying securities used to fund a portion of the Company's loan growth. Contributing to the increase in interest income on securities was a higher composition of tax free securities, and the higher tax-equivalent yields associated with them. The Company sold its portfolio of GSE CMOs in February 2016 and it took longer to deploy the funds into new loans than originally anticipated.

Interest expense on deposits and borrowings increased $1,116,000 from 2015 to 2016, as the average balance of interest-bearing liabilities increased $69,352,000, or 7.25%. Our cost of funds on interest-bearing liabilities also increased, from 0.45% for 2015 to 0.53% for 2016. The $910,000 increase, or 23 basis points, in interest expense on time deposits from 2015 to 2016 was the primary contributor to the overall increase.

Our ability to attract new deposits in all categories, but in particular interest-bearing demand deposits, resulted in an increase in average interest-bearing deposits. The Company has been able to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as it increases its commercial relationships. The cost of interest-bearing liabilities is influenced by changes in short-term interest rates. We also paid a higher rate on certain intermediate-term brokered deposits to help protect earnings from a rising rate environment and incurred $108,000 of accelerated interest expense on the call of brokered certificates of deposits in 2016.

The increase in deposits enabled us to decrease our use of short-term borrowings, which generally have higher interest rates associated with them. The average balance of short-term borrowings decreased $28,875,000 from 2015 to 2016. The average rate paid on short-term borrowings decreased 2 basis points from 2015 to 2016. We added to our long-term borrowings during 2016, with an average balance increase of $1,813,000 from 2015 to 2016, with an associated increase in expense of $19,000.

Provision for Loan Losses

The Company recorded a provision for loan losses of $1,000,000 and $250,000 in 2017 and 2016, and a negative provision for loan losses, or a reversal of amounts previously provided, of $(603,000) in 2015. In calculating the provision for loan losses, both quantitative and qualitative factors, including favorable historical charge-off data and stable economic and market conditions,were considered in the determination of the adequacy of the ALL. Net charge-offs and loan growth resulted in the determination that a provision expense was required in 2017 and 2016. The provision expense in 2017 principally reflected a charge-off on one commercial loan that was downgraded to nonaccrual status in the fourth quarter. The negative provision in 2015 was the result of a recovery on a loan with prior charge-offs totaling this amount, as well as significant improvement in asset quality metrics from prior years. Favorable charge-off data, combined with relatively stable economic and market conditions, resulted in the determination that a negative provision could be recorded in 2015 despite net charge-offs for the periods, as ALL coverage metrics remained strong.

See further discussion in the “Asset Quality” and “Credit Risk Management” sections of this Management’s Discussion and Analysis of Financial Condition and Results of Operations.

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Noninterest Income

The following table compares noninterest income for 2017, 2016 and 2015.

(Dollars in thousands)	2017	2016	2015	$ Change 2017-2016	$ Change 2016-2015	% Change 2017-2016	% Change 2016-2015
Service charges on deposit accounts	$5,675	$5,445	$5,226	$230	$ 219	4.2 %	4.2 %
Other service charges, commissions and fees	1,008	994	1,223	14	(229)	1.4 %	(18.7)%
Trust and investment management income	6,400	5,091	4,598	1,309	493	25.7 %	10.7 %
Brokerage income	1,896	1,933	2,025	(37)	(92)	(1.9)%	(4.5)%
Mortgage banking activities	2,919	3,412	2,747	(493)	665	(14.4)%	24.2 %
Earnings on life insurance	1,109	1,099	1,025	10	74	0.9 %	7.2 %
Other income	190	345	410	(155)	(65)	(44.9)%	(15.9)%
Subtotal before securities gains	19,197	18,319	17,254	878	1,065	4.8 %	6.2 %
Investment securities gains	1,190	1,420	1,924	(230)	(504)	(16.2)%	(26.2)%
Total noninterest income	$20,387	$19,739	$19,178	$648	$ 561	3.3 %	2.9 %

2017 versus 2016

Noninterest income increased $648,000 from 2016 to 2017. The following factors contributed to that net increase.

- Service charges on deposit accounts continued to increase in 2017 as a result of new product offerings and increased activity associated with deposit growth.
- Increased trust department income was realized throughout 2017 from favorable market conditions and the addition of an office in Berks County, Pennsylvania. Wheatland, which was acquired in December 2016, contributed approximately 39% of this increased revenue category in 2017.
- The decrease in mortgage banking activities reflects a combination of overall decreased refinance activity as interest rates have increased, some slight compression in sales profit margins that the Company has experienced and the portion of mortgage production retained for the Company's loan portfolio.
- Other income decreased in 2017 principally due to lower gains on sales of other real estate owned.
- In both 2017 and 2016, asset/liability management strategies resulted in net gains on sales of securities, as market and interest rate conditions presented opportunities to accelerate earnings on securities, while meeting funding requirements of the Company. In 2017, the Company repositioned a part of its investment portfolio at a gain to improve responsiveness of the portfolio to increases in short-term interest rates.

2016 versus 2015

Noninterest income increased $561,000 from 2015 to 2016. The following factors contributed to that net increase.

- Service charges on deposit accounts increased due principally to revenues generated from new cash management product offerings and higher interchange fees associated with increased usage by our customers
- Other service charges, commissions and fees decreased in comparing 2016 with 2015. In 2015, these revenues were favorably impacted by gains on sale of Small Business Administration and U.S. Department of Agriculture loans.
- Trust, investment management and brokerage income increased $401,000 for 2016 compared with 2015. Trust and brokerage income in 2016 included increased estate fees partially offset by lower brokerage income. The addition of Wheatland as an investment manager had a modest impact on 2016 revenues as that acquisition occurred in December 2016.
- Favorable interest rate conditions supported increased new home purchases and refinancing activity resulting in the increase in mortgage banking revenue.

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- Other income reflected, in part, decreased gains on sales of other real estate owned as well as changes due to customary business activities.
- For both years, asset/liability management strategies and interest rate conditions resulted in gains on sales of securities, as market conditions presented opportunities to accelerate earnings on securities through gains, while also meeting the funding requirements of current and anticipated lending activity.

Noninterest Expenses

The following table compares noninterest expenses for 2017, 2016 and 2015.

(Dollars in thousands)	2017	2016	2015	$ Change 2017-2016	$ Change 2016-2015	% Change 2017-2016	% Change 2016-2015
Salaries and employee benefits	$30,145	$26,370	$24,056	$3,775	$ 2,314	14.3 %	9.6 %
Occupancy	2,806	2,491	2,221	315	270	12.6 %	12.2 %
Furniture and equipment	3,434	3,335	3,061	99	274	3.0 %	9.0 %
Data processing	2,271	2,378	2,026	(107)	352	(4.5)%	17.4 %
Telephone and communication	647	740	692	(93)	48	(12.6)%	6.9 %
Automated teller machine and interchange fees	767	748	798	19	(50)	2.5 %	(6.3)%
Advertising and bank promotions	1,600	1,717	1,564	(117)	153	(6.8)%	9.8 %
FDIC insurance	606	775	859	(169)	(84)	(21.8)%	(9.8)%
Legal	802	850	1,440	(48)	(590)	(5.6)%	(41.0)%
Other professional services	1,571	1,332	1,262	239	70	17.9 %	5.5 %
Directors' compensation	996	969	737	27	232	2.8 %	31.5 %
Collection and problem loan	186	238	447	(52)	(209)	(21.8)%	(46.8)%
Real estate owned	69	239	162	(170)	77	(71.1)%	47.5 %
Taxes other than income	866	767	916	99	(149)	12.9 %	(16.3)%
Regulatory settlement	0	1,000	0	(1,000)	1,000	(100.0)%	100.0 %
Other operating expenses	3,564	4,191	4,366	(627)	(175)	(15.0)%	(4.0)%
Total noninterest expenses	$50,330	$48,140	$44,607	$2,190	$ 3,533	4.5 %	7.9 %

2017 versus 2016

Noninterest expenses increased $2,190,000 from 2016 to 2017. The following factors contributed to that net increase.

- The salaries and employee benefits increase includes the impact in 2017 of additional employees, including new customer-facing employees in targeted expansion markets, throughout 2016 and 2017. Higher costs in 2017 also include annual merit increases awarded in 2017, increased medical benefit costs for the expanded workforce and increased claim activity, incentive compensation increases and additional share-based awards granted in 2017.
- Occupancy and furniture and equipment expenses reflect a full period of expense for new facilities acquired in 2016 in Berks, Cumberland, Dauphin and Lancaster counties, Pennsylvania, as well as increases attributable to new facilities acquired in 2017 in Lancaster County, Pennsylvania.
- Advertising and bank promotion expense in 2016 included higher expenses related to expansion activities.
- The FDIC reached its 1.15% of insured funds target in June 2016, resulting in lower assessments. FDIC insurance expense in 2017 benefited from that lower assessment applied to our increased deposit base.
- Resolution of the SEC administrative proceedings in 2016 generally resulted in lower legal fees incurred in 2017. However, the Company incurred certain indemnification costs totaling $645,000, which is included in legal fees, with several professional service providers in 2017 in connection with previously disclosed outstanding litigation. Additional costs may be incurred as the litigation progresses.

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- In 2016, the Company agreed to pay a $1,000,000 civil money penalty to the Securities and Exchange Commission to settle administrative proceedings.
- Principal contributors to lower other operating expenses in 2017 were decreases in provision expense for off-balance sheet reserves on loans that have been committed to borrowers, but not funded, resulting from changes in qualitative factors similar to those used in the determination of the provision for loan losses, and reduced consumer fraud expenses.
- Other line items within noninterest expenses reflect are generally attributable to normal fluctuations in the conduct of business.

2016 versus 2015

Noninterest expenses increased $3,533,000 from 2015 to 2016. The following factors contributed to that net increase.

- The increase in salaries and employee benefits reflects the impact of adding new customer-facing employees in markets targeted for expansion as well as merit increases. Other drivers were additional medical expense incurred for new employees and increased claim activity, increased expense associated with supplemental executive compensation and compensation related to share-based awards granted in 2016.
- Consistent with our growth strategy in which new facilities were acquired in Berks, Cumberland, Dauphin and Lancaster counties, we experienced increases in occupancy, furniture and equipment expenses.
- Increases in data processing and telephone and communication expenses reflect our volume and physical growth and costs associated with more sophisticated product and service offerings.
- Advertising and bank promotion increased principally due to $100,000 of incremental Educational Improvement Tax Credit contributions (a component of Pennsylvania tax credits) made in 2016 and increased expenditures related to brand marketing and expansion in new markets.
- The Company benefited from a lower assessment rate as the FDIC reached its 1.15% of insured funds target on June 20, 2016.
- Legal fees decreased as the Company had higher than normal legal expenses in 2015 as it attended to legal matters, including outstanding litigation against the Company and an investigation with the SEC which began in the second quarter of 2015 and concluded in the third quarter of 2016. Although certain legal matters were ongoing, the legal expenses associated with them in 2016 were less than the levels in 2015.
- The increase in directors' compensation includes fees associated with two new directors added to the Board of Directors in 2016 and increased expense in 2016 for share-based compensation. In 2015, share-based compensation was only in effect for seven months of the year.
- Collection and problem loan expense decreased as a result of a lower level of classified loans that were being worked out by the Company. Partially offsetting this expense benefit was an increase in real estate owned expense of $77,000 from 2015 to 2016.
- A significant portion of the decrease in taxes, other than income, relates to incremental Educational Improvement Tax Credit contribution credits for qualifying contributions made in 2016 versus 2015, and which largely offset the related increase in advertising and bank promotions noted above.
- The Company incurred and paid a civil money penalty of $1,000,000 to the SEC in 2016 to settle administrative proceedings against the Company.
- Other line items within noninterest expenses reflect modest changes from 2015 to 2016 and are generally attributable to normal fluctuations in the conduct of business.

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Income Taxes

Income tax expense totaled $4,338,000, $1,266,000 and $1,634,000 for 2017, 2016 and 2015. As described more fully in Note 7, Income Taxes, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," due to tax reform enacted in 2017 the Company was required to remeasure its net deferred tax asset and incurred a tax expense of $2,635,000, which is included in total tax expense for 2017.

Note 7 also includes a reconciliation of our federal statutory tax rate to our effective tax rate, which is a meaningful comparison between years and measures income tax expense as a percentage of pretax income. The effective tax rate for 2017 was 34.9% compared with 16.0% for 2016 and 17.2% for 2015. Generally, our effective tax rate is lower than the federal statutory tax rate principally due to nontaxable interest earned on tax-free loans and securities and earnings on the cash surrender value of life insurance policies, offset partially by nondeductible expenses. In 2017, our higher effective tax rate was principally impacted by the tax expense incurred due to enacted tax reform. Effective January 1, 2016, the Company changed its statutory federal tax rate from 35% to 34% to reflect its assessment that it will not be in the higher tax bracket. As a result, income tax expense for 2016 increased $185,000 due to the application of the new rate to existing deferred balances.

Financial Condition

Management devotes substantial time to overseeing the investment of funds in loans and securities and the formulation of policies directed toward the profitability and management of the risks associated with these investments.

Securities Available for Sale

The Company utilizes securities available for sale to manage interest rate risk, to enhance income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings.

The Company has established investment policies and an asset management policy to assist in administering its investment portfolio. Decisions to purchase or sell these securities are based on economic conditions and management’s strategy to respond to changes in interest rates, liquidity, pledges to secure deposits and Repurchase Agreements and other factors while trying to maximize return on the investments. The Company may segregate its investment portfolio into three categories: “securities held to maturity,” “trading securities” and “securities available for sale.” Management has classified the entire securities portfolio as available for sale, which are accounted for at current market value with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of income taxes.

The Company’s securities available for sale portfolio includes debt and equity investments that are subject to varying degrees of credit and market risks, which arise from general market conditions, factors impacting specific industries, as well as news that may impact specific issues. Management monitors its debt securities, using various indicators in determining whether a debt security is other-than-temporarily impaired, including the extent of time the security has been in an unrealized loss position, and the extent of the unrealized loss. In addition, management assesses whether it is likely the Company will have to sell the security prior to recovery, or if it is able to hold the security until the price recovers. For those debt securities in which management concludes the security is other-than-temporarily impaired, it recognizes the credit component of an other-than-temporary impairment in earnings and the remaining portion in other comprehensive income. Given the strong asset quality of the debt security portfolio, the Company did not record any other-than-temporary impairment expense in 2017, 2016 or 2015.

For equity securities, when the Company has decided to sell an impaired available for sale security and does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell has not been made. The Company recorded no other-than-temporary impairment expense on equity securities for the years ended December 31, 2017, 2016 and 2015.

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The following table summarizes fair value of securities available for sale at December 31.

(Dollars in thousands)	2017	2016	2015
U.S. Government Agencies	$0	$39,592	$47,227
States and political subdivisions	159,458	164,282	125,961
GSE residential mortgage-backed securities	49,530	116,944	132,349
GSE residential CMOs	111,119	69,383	15,843
GSE commercial CMOs	0	4,856	63,770
Private label residential CMOs	1,003	5,006	8,901
Private label commercial CMOs	7,653	0	0
Asset-backed	86,431	0	0
Total debt securities	415,194	400,063	394,051
Equity securities	114	91	73
Totals	$415,308	$400,154	$394,124

The Company increased its investment portfolio in 2017 to generate additional interest income, with the average balance of securities increasing from $360,355,000 for the year ended December 31, 2016 to $420,583,000 for the year ended December 31, 2017.

In early 2017, the Company liquidated its U.S. Government Agencies investments in anticipation of a flattening yield curve, with funds reinvested in fixed rate CMOs. The Company also took advantage of historically wide spreads and higher interest rates to add modestly to its holdings of longer-term fixed rate securities issued by states and political subdivisions. In the second half of 2017, the Company reduced its holdings of seasoned GSE residential mortgage-backed securities and intermediate maturity taxable securities issued by states and political subdivisions and reinvested the proceeds in floating rate asset-backed securities in anticipation of further increases in short-term interest rates.

In 2016, as a result of interest rate market conditions, the Company liquidated its GSE commercial CMOs portfolio during the first quarter of 2016 at a net gain of $1,420,000. The proceeds from the sale were used to fund loan growth, reduce short-term borrowings and maintain liquidity for the first half of 2016. In the third quarter of 2016, the Company elected to reduce liquidity and enhance interest income through the purchase of securities, primarily GSE residential CMOs.

Management anticipates the loan portfolio will continue to grow in 2018. Asset backed securities, MBSs and CMOs provide monthly cash flows that may be used, in part, to meet this anticipated loan demand.

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The following table shows the maturities of investment securities at book value at December 31, 2017, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 34% federal income tax rate.

(Dollars in thousands)	Within 1 year	After 1 year but within 5 years	After 5 years but within 10 years	After 10 years	Total
States and political subdivisions					
Book value	$ 0	$ 8,712	$ 49,958	$95,133	$153,803
Yield	0.00 %	3.29 %	3.82 %	4.56 %	4.25 %
Average maturity (years)	0.0	3.9	8.0	16.4	12.9
GSE residential mortgage-backed securities					
Book value	0	0	0	48,600	48,600
Yield	0.00 %	0.00 %	0.00 %	2.57 %	2.57 %
Average maturity (years)	0.0	0.0	0.0	46.0	46.0
GSE residential CMOs					
Book value	0	0	0	113,658	113,658
Yield	0.00 %	0.00 %	0.00 %	2.07 %	2.07 %
Average maturity (years)	0.0	0.0	0.0	28.6	28.6
Private label residential CMOs					
Book value	0	0	0	999	999
Yield	0.00 %	0.00 %	0.00 %	2.34 %	2.34 %
Average maturity (years)	0.0	0.0	0.0	18.1	18.1
Private label commercial CMOs					
Book value	0	0	0	7,809	7,809
Yield	0.00 %	0.00 %	0.00 %	2.75 %	2.75 %
Average maturity (years)	0.0	0.0	0.0	17.4	17.4
Asset-backed					
Book value	0	0	3,808	82,979	86,787
Yield	0.00 %	0.00 %	2.30 %	2.31 %	2.31 %
Average maturity (years)	0.0	0.0	8.4	23.1	16.9
Total					
Book value	$ 0	$ 8,712	$ 53,766	$349,178	$411,656
Yield	0.00 %	3.29 %	3.72 %	2.89 %	3.01 %
Average maturity (years)	0.0	3.9	8.0	26.1	23.3

The average maturity is based on the contractual terms of the debt or mortgage-backed securities, and does not factor in required repayments or anticipated prepayments. At December 31, 2017, the weighted average estimated life is 5.1 years for mortgage-backed and CMO securities, and 8.3 years for asset-backed securities, based on current interest rates and anticipated prepayment speeds.

Loan Portfolio

The Company offers a variety of products to meet the credit needs of our borrowers, principally commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans secured by residential properties, and to a lesser extent, installment loans. No loans are extended to non-domestic borrowers or governments.

Generally, we are permitted under applicable law to make loans to single borrowers (including certain related persons and entities) in aggregate amounts of up to 15% of the sum of total capital and the ALL. The Company’s legal lending limit to one borrower was $22,100,000 at December 31, 2017. No borrower had an outstanding exposure exceeding the limit at year-end.

The risks associated with lending activities differ among loan classes and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans and general economic conditions. Any of these factors may adversely impact a borrower’s ability to repay loans, and also impact the associated collateral. A further discussion on the classes of loans

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the Company makes and related risks is included in Note 1, Summary of Significant Accounting Policies, and Note 4, Loans and Allowance for Loan Losses, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."
The following table presents the loan portfolio, excluding residential LHFS, by segments and classes at December 31.

(Dollars in thousands)	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014	December 31, 2013
Commercial real estate:					
Owner-occupied	$116,811	$112,295	$103,578	$100,859	$111,290
Non-owner occupied	244,491	206,358	145,401	144,301	135,953
Multi-family	53,634	47,681	35,109	27,531	22,882
Non-owner occupied residential	77,980	62,533	54,175	49,315	55,272
Acquisition and development:					
1-4 family residential construction	11,730	4,663	9,364	5,924	3,338
Commercial and land development	19,251	26,085	41,339	24,237	19,440
Commercial and industrial	115,663	88,465	73,625	48,995	33,446
Municipal	42,065	53,741	57,511	61,191	60,996
Residential mortgage:					
First lien	162,509	139,851	126,022	126,491	124,728
Home equity – term	11,784	14,248	17,337	20,845	20,131
Home equity – lines of credit	132,192	120,353	110,731	89,366	77,377
Installment and other loans	21,902	7,118	7,521	5,891	6,184
	$1,010,012	$883,391	$781,713	$704,946	$671,037

The loan portfolio at December 31, 2017 increased $126,621,000, or 14.3%, from December 31, 2016. Loan growth was experienced in most loan classes. We have hired and anticipate hiring additional lenders as we continue to grow in both core markets and in new markets, such as Lancaster and Dauphin counties, Pennsylvania, through expansion of our sales force and by capitalizing on continued disruption caused by the acquisition of some of our competitors by larger institutions. Commercial real estate experienced the largest dollar increase and grew by $64,049,000, or 14.9%. The residential mortgage loan segment grew $32,033,000, or 11.7%. Commercial and industrial loans grew $27,198,000, or 30.7%, and reflected management's additional emphasis in 2017 on growing this segment to increase portfolio diversification. In 2017, we also purchased approximately $15,000,000 of automobile financing loans, which are included in installment and other loans, at returns higher than comparable cash flows in the investment portfolio. Competition for new business opportunities remains strong, which may temper loan growth in future quarters.
In addition to monitoring our loan portfolio by loan class as noted above, we also monitor concentrations by industry. The Bank’s lending policy defines an industry concentration as one that exceeds 25% of the Bank’s total risk-based capital ("RBC"). The following industries met this criteria at December 31, 2017:

(Dollars in thousands)	Balance	% of Total Loans	% of Total RBC
Office space	$88,159	8.7%	59.2%
Strip retail shopping centers	41,929	4.2%	28.1%

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The following table presents expected maturities of certain loan classes by fixed rate or adjustable rate categories at December 31, 2017.

(Dollars in thousands)	Due In One Year or Less	One Year Through Five Years	After Five Years	Total
Acquisition and development:				
1-4 family residential construction				
Fixed rate	$0	$ 0	$ 6,138	$6,138
Adjustable and floating rate	4,734	0	858	5,592
	4,734	0	6,996	11,730
Commercial and land development				
Fixed rate	574	713	3,360	4,647
Adjustable and floating rate	1,639	374	12,591	14,604
	2,213	1,087	15,951	19,251
Commercial and industrial				
Fixed rate	757	36,428	16,064	53,249
Adjustable and floating rate	40,053	8,174	14,187	62,414
	40,810	44,602	30,251	115,663
	$47,757	$ 45,689	$ 53,198	$146,644

The final maturity is used in the determination of maturity of acquisition and development loans that convert from construction to permanent status. Variable rate loans shown above include semi-fixed loans that contractually will adjust with prime or LIBOR after the interest lock period, which may be up to 10 years. At December 31, 2017, these semi-fixed loans totaled $17,479,000.

Asset Quality

Risk Elements

The Company’s loan portfolio is subject to varying degrees of credit risk. Credit risk is mitigated through our underwriting standards, on-going credit reviews, and monitoring of asset quality measures. Additionally, loan portfolio diversification, which limits exposure to a single industry or borrower, and collateral requirements also mitigate our risk of credit loss.

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The following table presents the Company's risk elements and relevant asset quality ratios at December 31.

(Dollars in thousands)	2017	2016	2015	2014	2013
Nonaccrual loans (cash basis)	$9,843	$7,043	$16,557	$14,432	$19,347
Other real estate owned (OREO)	961	346	710	932	987
Total nonperforming assets	10,804	7,389	17,267	15,364	20,334
Restructured loans still accruing	1,183	930	793	1,100	5,988
Loans past due 90 days or more and still accruing	0	0	24	0	0
Total nonperforming and other risk assets	$11,987	$8,319	$18,084	$16,464	$26,322
Loans 30-89 days past due	$5,277	$1,218	$2,532	$1,612	$3,963
Ratio of:					
Total nonperforming loans to loans	0.97 %	0.80 %	2.12 %	2.05 %	2.88 %
Total nonperforming assets to assets	0.69 %	0.52 %	1.34 %	1.29 %	1.73 %
Total nonperforming assets to total loans and OREO	1.07 %	0.84 %	2.21 %	2.18 %	3.03 %
Total risk assets to total loans and OREO	1.19 %	0.94 %	2.31 %	2.33 %	3.92 %
Total risk assets to total assets	0.77 %	0.59 %	1.40 %	1.38 %	2.23 %
Allowance for loan losses to total loans	1.27 %	1.45 %	1.74 %	2.09 %	3.12 %
Allowance for loan losses to nonperforming loans	130.00 %	181.39 %	81.95 %	102.18 %	108.36 %
Allowance for loan losses to nonperforming loans and restructured loans still accruing	116.05 %	160.23 %	78.20 %	94.95 %	82.75 %

The following table provides detail of impaired loans at December 31, 2017 and 2016.

(Dollars in thousands)	2017 Nonaccrual Loans	2017 Restructured Loans Still Accruing	2017 Total	2016 Nonaccrual Loans	2016 Restructured Loans Still Accruing	2016 Total
Commercial real estate:						
Owner occupied	$1,185	$ 52	$1,237	$1,070	$ 0	$1,070
Non-owner occupied	4,065	0	4,065	736	0	736
Multi-family	165	0	165	199	0	199
Non-owner occupied residential	381	0	381	452	0	452
Acquisition and development						
1-4 family residential construction	492	0	492	0	0	0
Commercial and land development	0	0	0	1	0	1
Commercial and industrial	350	0	350	595	0	595
Residential mortgage:						
First lien	2,734	1,102	3,836	3,396	896	4,292
Home equity – term	22	0	22	93	34	127
Home equity – lines of credit	438	29	467	495	0	495
Installment and other loans	11	0	11	6	0	6
	$9,843	$ 1,183	$11,026	$7,043	$ 930	$7,973

Nonperforming assets include nonaccrual loans and foreclosed real estate. Risk assets, which incorporate nonperforming assets and restructured and loans past due 90 days or more and still accruing, totaled $11,987,000 at December 31, 2017, an increase of $3,668,000, or 44.1%, from $8,319,000 at December 31, 2016. Nonaccrual loans totaled $9,843,000 at December 31, 2017, an increase of $2,800,000 from December 31, 2016. Both measures principally reflect the addition of one commercial loan downgraded to nonaccrual status in the fourth quarter of 2017. The overall reduction of risk assets and

nonaccrual loans from December 31, 2015 to December 31, 2016 was due principally to the sale of a loan with a carrying balance of $5,946,000 to a third party. Cash proceeds totaled $5,100,000 with the $846,000 difference recorded as a charge-off to the ALL in 2016.

The ALL totaled $12,796,000 at December 31, 2017, a $21,000 increase from $12,775,000 at December 31, 2016, resulting from net charge-offs of $979,000 and a provision for loan losses of $1,000,000 for 2017. While the ALL is lower as a percentage of the total loan portfolio at December 31, 2017 than in prior years, management believes its coverage ratios are adequate for the risk profile of the loan portfolio given ongoing monitoring of the portfolio and its analysis performed at December 31, 2017. As new information is learned about borrowers or updated appraisals on real estate with lower fair values are obtained, the Company may continue to experience additional impaired loans.

For the years ended December 31, 2017, 2016, and 2015 recoveries of $287,000, $679,000 and $926,000 were credited to the ALL. These recoveries on previously charged-off relationships are the result of successful loan monitoring and workout solutions. Recoveries are difficult to predict, and any additional recoveries that the Company receives will be used to replenish the ALL. Recoveries favorably impact historical charge-off factors, and contribute to changes in quantitative as well as qualitative factors used in our allowance adequacy analysis. In 2015, a negative provision for loan losses was recorded. However, as the loan portfolio continues to grow, future provisions for loan losses may result.

The Company takes partial charge-offs on collateral-dependent loans when carrying value exceeds estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. Impairment reserves remain in place if updated appraisals are pending, and represent management's estimate of potential loss.

The following table presents exposure to relationships with an impaired loan balance, partial charge-offs taken to date and specific reserves established on the relationships at December 31, 2017 and 2016. Of the relationships deemed to be impaired at December 31, 2017, one had a recorded balance in excess of $1,000,000 and 62, or 91.2%, had recorded balances less than $250,000.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves
December 31, 2017				
Relationships greater than $1,000,000	1	$ 4,065	$ 791	$ 0
Relationships greater than $500,000 but less than $1,000,000	1	518	145	0
Relationships greater than $250,000 but less than $500,000	4	1,501	120	0
Relationships less than $250,000	62	4,942	1,160	51
	68	$ 11,026	$ 2,216	$ 51
December 31, 2016				
Relationships greater than $1,000,000	0	$ 0	$ 0	$ 0
Relationships greater than $500,000 but less than $1,000,000	2	1,327	620	0
Relationships greater than $250,000 but less than $500,000	2	640	120	0
Relationships less than $250,000	75	6,006	1,184	43
	79	$ 7,973	$ 1,924	$ 43

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. Credit Administration also reviews loans in excess of $1,000,000. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any reserves that may be needed. The determination of the Company's charge-offs or impairment reserve include an evaluation of the outstanding loan balance and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships at December 31, 2017. However, over time, additional information may

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

The Company’s foreclosed real estate balance consisted of two commercial properties totaling $961,000 at December 31, 2017. The Company believes the value of foreclosed real estate represents its fair value, but if the real estate values decline, additional charges may be needed. During 2017, no expense was recorded for writedown of other real estate owned properties.

Credit Risk Management

Allowance for Loan Losses

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

The ALL is evaluated based on review of the collectability of loans in light of historical experience; the nature and volume of the loan portfolio; adverse situations that may affect a borrower’s ability to repay; estimated value of any underlying collateral; and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve is included in Note 4, Loans and Allowance for Loan Losses, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."

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The following table summarizes the Company's internal risk ratings at December 31.

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
December 31, 2017						
Commercial real estate:						
Owner-occupied	$113,240	$ 413	$ 1,921	$ 1,237	$ 0	$116,811
Non-owner occupied	235,919	0	4,507	4,065	0	244,491
Multi-family	48,603	4,113	753	165	0	53,634
Non-owner occupied residential	76,373					