FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 16, 2015
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2014

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

(717) 264-6116

(Registrant's telephone number, including area code)

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

NONE

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

Common Stock, par value $1.00 per share

(Title of class)

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

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

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

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

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

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

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

The aggregate market value of the 3,880,155 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2014 based on the price of such shares was $77,215,085.

There were 4,226,816 outstanding shares of the Registrant's common stock as of February 28, 2015.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2014, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

FORM 10-K

INDEX

Part I

Item 1. Business

General

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

The Corporation's common stock is thinly traded in the over-the-counter market. The Corporation's stock is listed under the symbol "FRAF" www.otcmarkets.com/stock/FRAF/quote) on the OTCQX Market Tier of the OTC Markets. The Corporation's Internet address is www.franklinfin.com. Electronic copies of the Corporation's 2014 Annual Report on Form 10-K are available free of charge by visiting the "Investor Information" section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

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

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

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

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

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

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for repayment and are generally secured by business assets and personal guarantees. As such, this collateral may be more difficult to sell in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

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

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

The banking industry continued to watch the actions of the Federal Reserve in 2014, looking for any indication that it would announce an increase in short-term rates. The expectation of a rate increase faded as the year progressed, and any chance for a 2015 increase appears to be unlikely until the later part of 2015, if it happens at all. While the Federal Reserve did not change short-term rates in 2014, longer term Treasury yields fell over the course of the year and the 10-year Treasury fell below 2%. As a result, mortgage rates fell toward the end of 2014. The decline in mortgage rates, coupled with changes to regulatory agency policies on low down payment mortgages and mortgage insurance pricing, may help spur mortgage activity in 2015. Bond prices improved in 2014 due to the lower long-term rates and the stock market hit record highs. Oil prices have fallen well below $100 a barrel and the resulting lower gas prices will put more money in consumer's pockets. The unemployment rate dropped from nearly 7% at the start of the year, to below 6% at year end.

In 2014, Janet Yellen was confirmed as the first female chair of the Federal Reserve and her initial actions seem to indicate that she won't deviate much from plans put in place by her predecessor. The Federal Reserve's quantitative easing program of purchasing bonds ended in 2014; however, it will continue to actively reinvest cash flow into bonds.

From a regulatory perspective, Basel III (discussed further below) will be the big news for 2015 as its new capital requirements take effect in 2015. Also, regulatory attention on cyber security is likely to continue to increase as 2014 saw a number of large data breeches.

As mentioned, it appears as if the short-term rates will remain low until well into 2015. A prolonged period of low rates is not beneficial to improving the Bank's net interest margin. Commercial lending activity remained slow in 2014 with fewer credit worthy customers and many banks chasing a small group of good credit customers. Loan pricing was quite competitive and at times, well below rates the Bank believed to be profitable. Residential mortgage lending declined slightly as a mid-year uptick in rates slowed refinance activity. For more economic information about the Corporation's market area, see the Economy discussion in Item 7, Management's Discussion and Analysis.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are 24 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors with only an Internet site are present in the market. The Bank has 22 community offices and approximately 11% of the total deposits. The majority of the Bank's loan and deposit customers are in Franklin County. There are 6 commercial bank competitors in Franklin County and the Bank has approximately 30% of the deposit market share. The Bank's approximate deposit market share in other counties is: Fulton (37%), Cumberland (3%) and Huntingdon (2%).

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have declined and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors have access to resources (e.g., financial and technological) that are unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product, service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $1.001 billion on December 31, 2014.

Staff

As of December 31, 2014, the Corporation and its banking subsidiary had 266 full-time equivalent employees. The officers of the Corporation are employees of the Bank. Most employees participate in pension, incentive compensation plans, 401(k) plan and employee stock purchase plans and are provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

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

General

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

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

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

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank's primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications. The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act (CRA), assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank’s present CRA rating is “satisfactory.” Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

Capital Adequacy Guidelines

Bank holding companies are required to comply with the Federal Reserve Board's risk based capital guidelines. The required minimum ratio of total capital to risk weighted assets (including certain off balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be "Tier 1 capital," consisting principally of common shareholders' equity less certain intangible assets. The remainder ("Tier 2 capital") may consist of certain preferred stock, a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, and a limited amount of the general loan loss allowance and deferred tax accounts. The risk-based capital guidelines are required to take adequate account of interest rate risk, concentration of credit risk, and risks of nontraditional activities.

In addition to the risk based capital guidelines, the Federal Reserve Board requires a bank holding company to maintain a leverage ratio of a minimum level of Tier 1 capital (as determined under the risk based capital guidelines) equal to 3% of average total consolidated assets for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a ratio of at least 1% to 2% above the stated minimum. The Bank is subject to almost identical capital requirements adopted by the FDIC. In addition to FDIC capital requirements, the Pennsylvania Department of Banking also requires state chartered banks to maintain a 6% leverage capital level and 10% risk based capital, defined substantially the same as the federal regulations.

Basel III

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for U.S banks, generally referred to as “Basel III.” Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place. The capital ratios to be considered “well capitalized” under Basel III are: common equity of 6.5%, Tier 1 leverage of 5%, Tier 1 risk-based capital of 8%, and Total Risk-Based capital of 10%. The common equity ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.125%, increasing each year until fully implemented at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. Certain components of the new capital requirements are effective January, 2015 with others being phased in through January 1, 2019. As of December 31, 2014, Management believes that the Bank would remain “well capitalized’ under the new rules on a fully phased-in basis if such requirements were currently effective.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a "well capitalized" institution as "adequately capitalized" or require an "adequately capitalized" or "undercapitalized" institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2014, the Corporation and the Bank each satisfied the criteria to be classified as "well capitalized" within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks that are not classified as well capitalized or adequately capitalized may not pay dividends.

Volker Rule

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

Ability to Repay / Qualified Mortgages

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

Stress Testing

The Dodd-Frank Act requires stress testing by bank holding companies and banks having more than $10 billion but less than $50 billion of consolidated assets. Stress tests assess the potential impact of scenarios on the consolidated earnings, balance sheet and capital of a bank holding company or bank over a designated planning horizon of nine quarters, taking into account the organization's current condition, risks, exposures, strategies and activities. Although this provision of the Dodd-Frank Act and related regulations do not apply to the Corporation and the Bank because of their smaller sizes, federal banking regulators have indicated that stress testing is a "best practice" that is expected of all banks.

Pennsylvania Regulation and Supervision

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

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of $250,000 for each separately insured depositor. The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2014, the Bank was in risk category 1 and its assessment rate was approximately 9 basis points of the assessment base. Dodd-Frank established a new minimum DIF ratio set at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020 and its efforts to achieve this ratio could greatly influence future premium rates.

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

In addition to the FDIC assessments, the Financing Corporation ("FICO") is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature from 2017 to 2019. The Bank's FICO assessment was approximately $56 thousand in 2014 and was included in FDIC insurance expense.

New Legislation

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

Selected Statistical Information

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

Item 1A. Risk Factors

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

Risk Factors Relating to the Corporation

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

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2014, approximately 74% of its loans were secured by real estate. Loans to fund residential real estate construction are 1% of total loans; loans secured by residential real estate are 28% of the total, and commercial, industrial and agricultural real estate loans total 45% of the total loan portfolio. These real estate loans are located primarily in the Bank's market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. If a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. Localized events that affect real estate prices and collateral values could have a more negative affect on the Bank as compared to other competitors with a more geographically diverse portfolio. As the Bank grows, it is expected that the percentage of real estate loans, specifically commercial real estate, will grow. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

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

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

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

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

The Bank's lending limit is approximately $15.7 million. Accordingly, the size of the loans that can be offered to customers is less than the size of loans that many of our competitors, with larger lending limits, can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

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

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

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

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

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

We rely heavily on communications and information systems to conduct our business. These systems include both our internal network and data systems, as well as those of third party vendors. Any failure, interruption or breach in security or these systems, including a cyber-attack, could result in the disclosure or misuse of confidential or proprietary information. While we have systems, policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of client business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

Risk Factors Relating to the Common Stock

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

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

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

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

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

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

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

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

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

Not Applicable

Part II

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

Market and Dividend Information

The Corporation's common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote). The range of high and low prices is shown in the following table for the years 2014 and 2013, as well as cash dividends declared for those periods. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2014 was $22.00. The Corporation had 1,943 shareholders of record as of December 31, 2014.

Market and Dividend Information

	2014			2013		
(Dollars per share)			Dividends			Dividends
	High	Low	Declared	High	Low	Declared
First quarter	$ 18.75	$ 17.00	$ 0.17	$ 18.00	$ 13.82	$ 0.17
Second quarter	20.25	17.75	0.17	17.50	15.60	0.17
Third quarter	21.75	19.26	0.17	16.85	15.81	0.17
Fourth quarter	23.50	20.50	0.17	17.60	15.95	0.17
			$ 0.68			$ 0.68

Restrictions on the Payment of Dividends

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

Securities Authorized for Issuance under Equity Compensation Plans

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading " Executive Compensation – Compensation Tables" in the Corporation's Proxy Statement for the 2015 Annual Meeting of Shareholders.

Common Stock Repurchases

The Corporation frequently authorizes the repurchase of its common stock through a stock repurchase plan. There was no stock repurchase plan in place during 2014. The common shares of the Corporation are purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits, employee benefit and executive compensation plans, and the dividend reinvestment plan. The Corporation did not repurchase any shares in 2014 or 2013.

Performance Graph

The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ – Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business) and with the Northeast OTC-BB and Pink Banks Index (an industry-specific index prepared by SNL Financial LC) for the five year period ended December 31, 2014, in each case assuming an initial investment of $100 on December 31, 2009 and the reinvestment of all dividends.

	Period Ending					
Index	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14
Franklin Financial Services Corporation	$ 100.00	$ 119.04	$ 85.71	$ 102.66	$ 130.83	$ 174.40
NASDAQ Composite	$ 100.00	$ 118.15	$ 117.22	$ 138.02	$ 193.47	$ 222.16
SNL Northeast OTC-BB & Pink Banks	$ 100.00	$ 108.89	$ 106.59	$ 122.78	$ 144.93	$ 166.16

Shareholders’ Information

Dividend Reinvestment Plan:

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

Dividend Direct Deposit Program:

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

Annual Meeting:

The Annual Shareholders’ Meeting will be held on Tuesday, April 28, 2015, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, PA. The Business Meeting will begin at 9:00 a.m. with breakfast provided.

Websites:

Franklin Financial Services Corporation:	www.franklinfin.com
Farmers & Merchants Trust Company:	www.fmtrustonline.com

Stock Information:

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

Registrar and Transfer Agent:

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

Item 6. Selected Financial Data

	Summary of Selected Financial Data for the Year Ended December 31				
	2014	2013	2012	2011	2010
(Dollars in thousands, except per share)					
Summary of Operations					
Interest income	$ 34,794	$ 36,042	$ 39,142	$ 41,791	$ 43,284
Interest expense	3,180	4,378	6,890	9,154	12,443
Net interest income	31,614	31,664	32,252	32,637	30,841
Provision for loan losses	764	2,920	5,225	7,524	3,235
Net interest income after provision for loan losses	30,850	28,744	27,027	25,113	27,606
Noninterest income	10,861	9,877	9,451	10,200	9,366
Noninterest expense	31,303	31,094	30,601	28,333	26,423
Income before income taxes	10,408	7,527	5,877	6,980	10,549
Income tax	2,006	1,295	512	411	2,937
Net income	$ 8,402	$ 6,232	$ 5,365	$ 6,569	$ 7,612
Performance Measurements					
Return on average assets	0.83%	0.61%	0.51%	0.66%	0.78%
Return on average equity	8.44%	6.72%	6.00%	7.68%	9.34%
Return on average tangible assets (1)	0.87%	0.64%	0.55%	0.70%	0.82%
Return on average tangible equity (1)	9.72%	7.86%	7.14%	9.30%	11.27%
Efficiency ratio (1)	70.83%	72.01%	70.44%	63.46%	63.43%
Net interest margin	3.56%	3.47%	3.50%	3.73%	3.53%
Current dividend yield	3.09%	3.98%	4.86%	8.74%	5.92%
Dividend payout ratio	33.88%	45.09%	59.09%	65.05%	55.10%
Shareholders' Value (per common share)					
Diluted earnings per share	$ 2.00	$ 1.51	$ 1.32	$ 1.66	$ 1.96
Basic earnings per share	2.01	1.51	1.32	1.66	1.96
Regular cash dividends paid	0.68	0.68	0.78	1.08	1.08
Book value	24.54	22.88	22.31	21.67	21.09
Tangible book value (1)	22.36	20.55	19.84	19.04	18.28
Market value	22.00	17.10	14.00	12.35	18.25
Market value/book value ratio	89.65%	74.74%	62.75%	56.99%	86.53%
Price/earnings multiple	11.00	11.32	10.61	7.44	9.31
Balance Sheet Highlights					
Total assets	$ 1,001,448	$ 984,587	$ 1,027,363	$ 990,248	$ 951,889
Investment securities	171,751	159,674	133,328	125,301	117,616
Loans, net	717,420	713,711	743,200	756,687	739,841
Deposits and customer repurchase agreements	890,260	869,558	916,649	841,089	785,495
Shareholders' equity	103,521	95,388	91,634	87,182	82,639
Safety and Soundness					
Risk-based capital ratio (Total)	15.49%	14.24%	12.60%	12.14%	11.73%

Leverage ratio (Tier 1)	9.69%	9.14%	8.29%	8.40%	8.16%
Common equity ratio	10.34%	9.69%	8.92%	8.80%	8.68%
Tangible common equity ratio (1)	9.51%	8.79%	8.01%	7.82%	7.61%
Nonperforming loans/gross loans	1.74%	3.49%	4.90%	2.94%	3.68%
Nonperforming assets/total assets	1.63%	3.04%	4.10%	2.60%	2.96%
Allowance for loan losses as a % of loans	1.25%	1.34%	1.38%	1.27%	1.18%
Net charge-offs/average loans	0.19%	0.49%	0.60%	0.86%	0.45%
Trust assets under management (fair value)	$ 605,796	$ 574,680	$ 520,434	$ 481,536	$ 490,420

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

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

Application of Critical Accounting Policies:

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

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

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

The analysis has two components, specific and general allocations. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank’s historical loan loss experience and other qualitative factors derived from economic and market conditions are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was $9.1 million at December 31, 2014.

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

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

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

Restricted Stock - Restricted stock, which is carried at cost, consists of stock of the Federal Home Loan Bank of Pittsburgh (FHLB) and Atlantic Community Bankers Bank (ACBB). Management evaluates the restricted stock for impairment in accordance with ASC Topic 320. Management’s determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the banks as compared to the capital stock amount for the banks and the length of time this situation has persisted, (2) commitments by the banks to make payments required by law or regulation and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the banks.

Stock-based Compensation – The Corporation has two stock compensation plans in place consisting of an Employee Stock Purchase Plan (ESPP) and an Incentive Stock Option Plan (ISOP).

The Corporation accounts for stock compensation plans in accordance with FASB Accounting Standards Codification Topic 718, "Stock Compensation." ASC Topic 718 requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

The Corporation calculates the compensation cost of the options by using the Black-Scholes method to determine the fair value of the options granted. In calculating the fair value of the options, the Corporation makes assumptions regarding the risk-free rate of return, the expected volatility of the Corporation's common stock, dividend yield and the expected life of the option. These assumptions are made independently for the ESPP and the ISOP and if changed, would change the compensation cost of the options and net income. Note 1 of the accompanying financial statements provides additional information about stock option expense.

Federal Income Taxes – Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance, when in the opinion of management, it is more likely than not that some portion or all deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the date of enactment. ASC Topic 740 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more-likely-than-not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. ASC Topic 740, "Income Taxes" also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

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

GAAP versus Non-GAAP Presentations – The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets, Return on Average Tangible Equity, Tangible Book Value and Tangible Common Equity ratio. As a result of merger transactions, intangible assets (primarily goodwill, core deposit intangibles and customer list) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. However, not all companies use the same calculation methods for the same non-GAAP measurements and therefore may not be comparable. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

GAAP Measurement	Calculation
Return on Average Assets	Net Income / Average Assets
Return on Average Equity	Net Income / Average Equity
Book Value	Total Shareholders' Equity / Shares Outstanding
Common Equity Ratio	Total Shareholders' Equity / Total Assets

Non- GAAP Measurement	Calculation
Return on Average Tangible Assets	Net Income plus Intangible Amortization (net of tax) / Average Assets less Average Intangible Assets
Return on Average Tangible Equity	Net Income plus Intangible Amortization (net of tax) / Average Equity less Average Intangible Assets
Tangible Book Value	Total Shareholders' Equity less Intangible Assets / Shares outstanding
Tangible Common Equity Ratio	Total Shareholders' Equity less Intangible Assets / Total Assets less Intangible Assets
Efficiency Ratio	Noninterest Expense / Tax Equivalent Net Interest Income plus Noninterest Income less Net Securities Gains

Results of Operations:

Management's Overview

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

Franklin Financial Services Corporation reported a 34.8% increase in net income for 2014. Net interest income remained flat year over year at approximately $31.6 million; however, net income increased by $2.2 million due to a similar reduction in the provision for loan losses. The Corporation continued to see a reduction in loan charge-offs and an improvement in the quality of its loan portfolio that allowed for a lower provision expense. Noninterest income increased by 10% in 2014 compared to 2013, with nearly every category of noninterest income showing an increase. Noninterest expense held steady during the year with only a minimal increase of $209 thousand over 2013. Diluted earnings per share increased from $1.51 in 2013 to $2.00 in 2014. The Corporation declared and paid a dividend of $0.68 per share. After closing 2013 at just under $1.0 billion in assets, the balance sheet grew slightly and closed 2014 at $1.001 billion. Net loans increased $3.7 million as residential real estate, and commercial loans increased while consumer and commercial real estate loans declined year over year. Deposits increased $35.5 million due to increases in interest-bearing checking accounts, due in part to a shift from Repo accounts to deposit accounts. Shareholders' equity continued to increase during the year from retained earnings and investments from the dividend reinvestment plan. Other key performance measurements are presented in Item 6, Selected Financial Data.

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

Net Interest Income

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

2014 versus 2013

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

Assets: Table 3 shows the average balance and yield on the major asset classes on the Corporation's balance sheet. Total average interest-earning assets decreased by $13.0 million and the yield fell from 3.93% in 2013 to 3.89% in 2014. The low interest rate environment that continues to be supported by Federal Reserve actions continues to push asset yields down on both new assets and the repricing of existing assets.

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

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

The average balance of the loan portfolio declined by approximately $5 million for 2014 as compared to the average balance for 2013. Residential mortgage and home equity balances increased during the year, but these increases were not sufficient enough to offset the decline in commercial and consumer loans. Commercial lending continued to be very competitive in 2014, with a lot of low rate competition seeking out the best customers. The decline in the 2014 average commercial loan portfolio was driven by some accelerated payoffs at the end of 2013 and the beginning of 2014. However, from year-end 2013 to year-end 2014, the commercial loan portfolio increased. The average balance of the mortgage portfolio increased due to more refinancing activity during the year. Home equity production in 2014 was good, but was boosted by a low rate promotion. The average yield on the loan portfolio declined to 4.28% in 2014 from 4.54% in 2013. All categories, except consumer loans, experienced a lower yield in 2014. Approximately 82% of the commercial loan portfolio is variable rate with rates tied to short-term market rates like Prime or Libor. Until there is an increase in short-term rates, the yield on the commercial loan portfolio is likely to decline.

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

Table 2 shows the affect volume and rate had on the change in tax equivalent net interest income in 2014.

2013 versus 2012

Summary: Tax equivalent net interest income (Table 1) declined by 2% during 2013. The average balance of interest-earning assets declined during the year and the yield on these assets fell by 29 basis points; therefore, tax-equivalent interest income declined (see Table 3). Likewise, Table 3 also shows that the average balance of interest-bearing liabilities declined during the year and the cost of these deposits also fell by 29 basis points. As a result, tax-equivalent net interest income declined by $675 thousand and the net interest margin as a percentage of earning assets fell from 3.50% in 2012 to 3.47% in 2013. Table 2 shows that changes in interest rates had a larger negative effect on net interest income than did the changes in the balance sheet.

Assets: Table 3 shows the average balance and yield on the major asset classes on the Corporation’s balance sheet. Average interest earning assets and the yield on these assets declined during 2013. The low interest rate environment that continues to be supported by Federal Reserve actions continues to push asset yields down on both new assets and the repricing of existing assets.

The investment portfolio averaged $152.6 million in 2013 compared to $134.7 million in 2012. Despite the increase in the average balance, the yield on the portfolio declined from 2.96% in 2012 to 2.68% in 2013. The Bank purchased $69.1 million of new securities in 2013, primarily in the U.S. Government Agency mortgaged backed securities sector.

Average loan balances fell during the year, with every category showing a reduction from the 2012 averages except for residential mortgages. The commercial loan portfolio declined $34.3 million and the yield fell by 20 basis points during the year. The low interest rate environment continues to be an incentive for pre-payments and refinancing, and good quality credits are in demand by many lenders eager to increase volume. As a result, the Bank has lost some balances to prices that it felt was unable to match. The bank retained more of its mortgage production in 2013; therefore, the average balance increased during the year. However, the yield on the mortgage portfolio declined year over year. The Bank retained primarily shorter-term mortgages and sold longer-term mortgages in the secondary market.

Consumer lending, including home equity products, continued to decline. Home equity products declined, on average by approximately $7 million compared to 2012 and the yield fell by 32 basis points. Both products have seen new production rates decline, but the lower volume was the largest factor contributing to the decline in interest income on these products.

Liabilities: The average balance of interest-bearing liabilities declined by $15.9 million in 2013 and the cost fell by 29 basis points. Every category of interest-bearing deposits, except time deposits (CDs) increased during the year. The interest-bearing checking and money management accounts showed the largest balance increases. The increase in interest checking and money management came primarily in the municipal account categories in the Bank's fully insured deposit products. The average balance of CDs declined primarily due to a reduction in brokered CDs. The reduction in brokered CDs was due to action taken by the Bank to "call" and payoff higher rate brokered CDs, and by scheduled maturities. The cost of interest-bearing deposits fell from .70% in 2012 to .50% in 2013 driven down by an 18 basis point reduction on the rate of the money management product.

The average balance of securities sold under agreements to repurchase declined by $19.2 million as the Bank has been transitioning these accounts to a fully insured checking account product. Average long-term debt declined significantly year over year due to the Bank prepaying $33.1 million of FHLB advances in 2012. The Bank did not prepay any FHLB advances in 2013 or take any new advances.

Table 1. Net Interest Income

(Dollars in thousands)	2014	% Change	2013	% Change	2012
Interest income	$ 34,794	(3.5)	$ 36,042	(7.9)	$ 39,142
Interest expense	3,180	(27.4)	4,378	(36.5)	6,890
Net interest income	31,614	(0.2)	31,664	(1.8)	32,252
Tax equivalent adjustment	1,978		1,596		1,683
Tax equivalent net interest income	$ 33,592	1.0	$ 33,260	(2.0)	$ 33,935

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

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

	2014 Compared to 2013 Increase (Decrease) due to:			2013 Compared to 2012 Increase (Decrease) due to:		
Increase (Decrease) due to: (Dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	$ (96)	$ 65	$ (31)	$ (6)	$ 12	$ 6
Investment securities:						
Taxable	271	584	855	271	(213)	58
Nontaxable	214	(167)	47	138	(101)	37
Loans:						
Commercial, industrial and agricultural	(351)	(1,001)	(1,352)	(1,544)	(1,219)	(2,763)
Residential mortgage	190	(147)	43	801	(529)	272
Home equity loans and lines	23	(364)	(341)	(412)	(206)	(618)
Consumer	(154)	67	(87)	(158)	(21)	(179)
Loans	(292)	(1,445)	(1,737)	(1,313)	(1,975)	(3,288)
Total net change in interest income	97	(963)	(866)	(910)	(2,277)	(3,187)
Interest expense on:						
Interest-bearing checking	31	41	72	40	30	70
Money market deposit accounts	(2)	(197)	(199)	132	(692)	(560)
Savings accounts	2	(7)	(5)	5	(16)	(11)
Time deposits	(411)	(553)	(964)	(556)	(277)	(833)
Securities sold under agreements to repurchase	(36)	1	(35)	(28)	(2)	(30)
Long-term debt	(64)	(3)	(67)	(1,054)	(94)	(1,148)
Total net change in interest expense	(480)	(718)	(1,198)	(1,461)	(1,051)	(2,512)
Change in tax equivalent net interest income	$ 577	$ (245)	$ 332	$ 551	$ (1,226)	$ (675)

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

Table 3. Analysis of Net Interest Income

	2014			2013			2012		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Averag yield/r
Interest-earning assets:									
Interest-bearing obligations of other banks and federal funds sold	$ 43,457	$ 182	0.42%	$ 70,115	$ 213	0.30%	$ 72,056	$ 207	0.29
Investment securities:									
Taxable	124,903	2,718	2.18%	110,194	1,863	1.69%	94,914	1,805	1.90
Nontaxable	46,663	2,268	4.86%	42,399	2,221	5.24%	39,822	2,184	5.48
Investments	171,566	4,986	2.91%	152,593	4,084	2.68%	134,736	3,989	2.96
Loans:									
Commercial, industrial and agricultural	579,314	24,537	4.24%	587,359	25,889	4.41%	621,702	28,652	4.61
Residential mortgage	82,706	3,409	4.12%	78,185	3,366	4.31%	60,704	3,094	5.10
Home equity loans and lines	60,099	3,102	5.16%	59,706	3,443	5.77%	66,719	4,061	6.09
Consumer	7,693	556	7.23%	9,902	643	6.49%	12,334	822	6.66
Loans	729,812	31,604	4.33%	735,152	33,341	4.54%	761,459	36,629	4.81
Total interest-earning assets	944,835	36,772	3.89%	957,860	37,638	3.93%	968,251	40,825	4.22
Other assets	71,160			72,035			73,565		
Total assets	$ 1,015,995			$ 1,029,895			$ 1,041,816		
Interest-bearing liabilities:									
Deposits:									
	$ 203,065	228	0.11%	$ 172,079	156	0.09%	$ 122,870	86	0.07

Interest-bearing checking									
Money Management	387,297	1,687	0.44%	387,607	1,886	0.49%	366,857	2,446	0.67%
Savings	62,603	48	0.08%	60,147	53	0.09%	55,113	64	0.12%
Time	106,391	780	0.73%	147,915	1,744	1.18%	193,120	2,577	1.33%
Total interest-bearing deposits	759,356	2,743	0.36%	767,748	3,839	0.50%	737,960	5,173	0.70%
Securities sold under agreements to repurchase	8,539	13	0.15%	32,407	48	0.15%	51,558	78	0.15%
Short- term borrowings	-	-	-	3	-	0.75%	-	-	-
Long- term debt	10,778	424	3.93%	12,409	491	3.96%	38,920	1,639	4.21%
Total interest-bearing liabilities	778,673	3,180	0.41%	812,567	4,378	0.54%	828,438	6,890	0.83%
Noninterest-bearing deposits	129,748			116,724			110,657		
Other liabilities	8,062			7,818			13,170		
Shareholders' equity	99,512			92,786			89,551		
Total liabilities and shareholders' equity	$ 1,015,995			$ 1,029,895			$ 1,041,816		
T/E net interest income/Net interest margin		33,592	3.56%		33,260	3.47%		33,935	3.50%
Tax equivalent adjustment		(1,978)			(1,596)			(1,683)	
Net interest income		$ 31,614			$ 31,664			$ 32,252	

Provision for Loan Losses

For 2014, the Bank recorded net charge-offs of $1.4 million compared to $3.6 million in 2013. The charge-offs were more than the 2014 provision expense of $764 thousand and as a result, the allowance for loan losses (ALL) decreased $591 thousand over year-end 2013. The Corporation experienced a significant fluctuation in its provision expense over the last four years. As credit quality improved in 2014, the provision expense primarily for the specific reserve, declined. The Corporation expects the 2015 provision expense to return to a more normalized level as compared to the most recent experience. At December 31, 2014, the ALL was $9.1 million or 1.25% of total loans compared to a ratio 1.34% at the end of 2013. Nonperforming assets declined during the year and Management closely monitors the credit quality of the portfolio in order to ensure that an appropriate ALL is maintained. As part of this process, Management performs a comprehensive analysis of the loan portfolio considering delinquencies trends and events, current economic conditions, and other relevant factors to determine the adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Loan Quality discussion and Tables 12 -17.

Noninterest Income

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

Table 4. Noninterest Income

	December 31		Change	
(Dollars in thousands)	2014	2013	Amount	%
Noninterest Income				
Investment and trust services fees	$ 4,575	$ 4,429	$ 146	3.3
Loan service charges	917	879	38	4.3
Mortgage banking activities	37	47	(10)	(21.3)
Deposit service charges and fees	2,094	1,831	263	